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FINANCIAL CONDITION OF THE BANK AND THRIFT INDUSTRIES

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HEARINGS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

PART 2

OCTOBER 2, 3, AND 17, 1985

Serial No. 99-60

Printed for the use of the Committee on Banking, Finance and Urban Affairs

ORIGINAL

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I

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CONTENTS

Page

Hearings held on:
- October 2, 1985 829
- October 3, 1985 1033
- October 17, 1985 1321

WITNESSES

Wednesday, October 2, 1985

Benston, George J., professor of accounting, economics and finance, Graduate School of Management, University of Rochester 832
- Prepared statement 839

Eisenbeis, Robert A., professor of banking, University of North Carolina at Chapel Hill 866
- Prepared statement 873

Huertas, Thomas F., vice president, Citibank, N.A 891
- Prepared statement with an attached paper entitled, "Deposit Insurance: Overhaul or Tuneup" 895

Lumpp, Roger E., II, vice president, CNA Insurance Co's 961
- Prepared statement 966

Material Submitted for Inclusion in the Record

Benston, George J., response to written questions of Chairman Fernand J. St Germain 1014

Manton, Hon Thomas J., a Representative in Congress from the State of New York, opening statement 831

Letters of invitation to witnesses for this day 1010

Thursday, October 3, 1985

Backlund, B.F. (Chip), on behalf of the Independent Bankers Association of America [IBAA] 1059
- Prepared statement 1063

Cairns, James G., Jr., on behalf of the American Bankers Association [ABA] 1033
- Prepared statement 1037

Edgerly, William S., chairman, State Street Bank & Trust Co., Boston, MA, on behalf of the Association of Reserve City Bankers 1100
- Prepared statement 1103

King, George C., vice president, board of directors, National Association of State Savings and Loan Supervisors 1239
- Prepared statement 1242

Levy, Gerald, president, Guaranty Savings and Loan Association, Milwaukee, WI, on behalf of the U.S. League of Savings Institutions 1141
- Prepared statement with attached appendixes 1144

McEnteer, Ben, secretary of banking of the Commonwealth of Pennsylvania, on behalf of the Conference of State Bank Supervisors 1114
- Prepared statement 1116

Rutland, George P., vice chairman and chief executive officer, California Federal Savings and Loan Association, Los Angeles, CA, on behalf of the National Council of Savings Institutions 1217
- Prepared statement 1219

MATERIAL SUBMITTED FOR INCLUSION IN THE RECORD

Page

International Share and Deposit Guaranty Association, statement with attachments submitted on behalf by Charles W. Filson, professional staff, Callahan and Associates, Bethesda, MD 1295
Letters of invitation to witnesses of this day 1281

THURSDAY, OCTOBER 17, 1985

Gray, Hon. Edwin J., Chairman, Federal Home Loan Bank Board [FHLBB] 1477
  Prepared statement 1481

MATERIAL SUBMITTED FOR INCLUSION IN THE RECORD

Bankers' Association for Foreign Trade, letter from David H. Dorminey, president, dated October 10, 1985, with attached statement 1609
Charts—"Depository Institutions Statistical Information," prepared by the subcommittee staff with the assistance of Dr. William Jackson, Congressional Research Service, dated October 17, 1985 1591
Fitzgerald, Gerald F., chairman of the board, Suburban Bancorp, Inc., Palatine, IL, letter with attached document "F.D.I.C. Narrative," dated September 26, 1985 1596
Gray, Hon. Edwin J.:
  Letter of invitation 1627
  Response to questions of:
    Chairman St Germain 1539, 1577, 1580
    Hon. Stewart B. McKinney 1545
    Hon. Chalmers P. Wylie 1554
Isaac, Hon. William M., Chairman, Federal Deposit Insurance Corporation [FDIC], statement 1459
Staff memorandum on the subject: FHLBB proposal: "Thrift Regulatory Improvements Act of 1985," dated October 16, 1985 1442
Text of:
  H.R. 1680 1324
  Section-by-section analysis 1395
  H.R. 2444 1447
  Section-by-section analysis 1457

FINANCIAL CONDITION OF THE BANK AND THRIFT INDUSTRIES

WEDNESDAY, OCTOBER 2, 1985

House of Representatives,

Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, at 10 a.m., in room 2128 of the Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Chairman St Germain; Representatives Barnard, Kaptur, Manton, Wylie, McKinney, Wortley, Parris, and Roth.

Chairman St Germain. The subcommittee will come to order. During the past several weeks, this subcommittee has heard testimony on virtually all aspects of the Federal deposit insurance reform question. We heard first from the top supervisory officials at each of the regulatory agencies regarding the financial condition of the institutions they oversee. From what they told the subcommittee the need for intensified supervisory efforts is clear.

We then heard from the officials responsible for the management of each of the Federal deposit insuring funds—the Federal Deposit Insurance Corporation, Federal Savings and Loan Insurance Corporation, and the National Credit Union Share Insurance Fund. While each of the funds faces its own unique challenges, each, with the full faith and credit backing of the U.S. Government, is fully able to carry out its statutory responsibilities.

We then heard from the "wise men" of academia—the holders of the endowed chairs in finance and economics at the major universities and the senior analysts at the "think tanks." Their analyses and presentations have been carefully reasoned although conflicting. Nevertheless, they have provided this subcommittee with the best arguments for and against many possible insurance reforms. For this we are grateful.

Today, we continue with testimony from more academic, finance, and insurance experts—George Benston of the University of Rochester, Robert Eisenbeis of the University of North Carolina at Chapel Hill, Thomas Huertas of Citibank, and Roger Lumpp of the CNA Insurance Co. Tomorrow we will hear from the trade associations, and in the coming weeks from the heads of the FDIC and FSLIC, and the Federal Reserve.

The chair recognizes Mr. Wylie.

Mr. Wylie. Thank you very much, Mr. Chairman. I welcome our very distinguished panel and I look forward very much to your testimony. Lord knows, we can use all the help we can get in trying to resolve this dilemma which we now face.

I do not have a formal opening statement this morning, Mr. Chairman. Thank you for the opportunity to welcome our panel.

Chairman St Germain. Thank you.

We have an opening statement of Congressman Thomas J. Manton of New York that I will insert in the record at this point.

[The opening statement follows:]

OPENING STATEMENT OF
CONGRESSMAN THOMAS J. MANTON
BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
OCTOBER 2, 1985

MR. CHAIRMAN, I WANT TO COMMEND YOU FOR HOLDING THESE HEARINGS ON FEDERAL DEPOSIT INSURANCE REFORM. THESE HEARINGS ARE INDEED TIMELY GIVEN THE CURRENT AND GROWING STRAINS ON THE INSURANCE SYSTEM.

IN THE EARLY 1930'S, THE FEDERAL DEPOSIT INSURANCE CORPORATION (F.D.I.C.) AND THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION (F.S.L.I.C.) WERE CREATED TO RESTORE FAITH AND CONFIDENCE IN THE NATION'S BANKING SYSTEM. OVER THE PAST FIFTY YEARS, THE INSURANCE SYSTEM HAS EVOLVED FROM A PROGRAM DESIGNED PRIMARILY TO PROTECT THE SMALL DEPOSITOR TO A PROGRAM WHICH CURRENTLY INSURES DEPOSITS UP TO $100,000. FURTHERMORE, THE INSURANCE SYSTEM HAS BEEN USED TO FACILITATE MERGERS OF FAILING BANKS WITH HEALTHY ONES.

TODAY, THE PROGRAM IS FACING A SERIOUS CRISIS. WHILE THE FDIC FUND IS ON RELATIVELY SOUND FINANCIAL FOOTING, THE FSLIC FUND IS ON THE BRINK OF FAILURE. THE PRIMARY CAUSES OF THE CURRENT CRISIS ARE RECORD BANK FAILURES, AND THE CHANGING NATURE OF BANKING. QUITE SIMPLY, THE FUNDS, PRINCIPALLY THE FSLIC, NEED ADDITIONAL CAPITAL.

NUMEROUS PROPOSALS ARE BEFORE CONGRESS TO ENHANCE THE SOUNDNESS OF THE DEPOSIT INSURANCE SYSTEM. THESE HEARINGS ARE AN IMPORTANT FIRST STEP IN THAT DIRECTION.

MR. CHAIRMAN, I LOOK FORWARD TO HEARING FROM THE WITNESSES.

Chairman **St Germain**. At this time, without objection, we will put all of the statements of the witnesses in the record. And as I call upon you, you may proceed to summarize those statements.

Our first witness will be George Benston, who is a professor of accounting at the University of Rochester. Professor Benston.

STATEMENT OF GEORGE J. BENSTON, PROFESSOR OF ACCOUNTING, ECONOMICS AND FINANCE, GRADUATE SCHOOL OF MANAGEMENT, UNIVERSITY OF ROCHESTER

Mr. **Benston**. The study I've done relates directly to the question at issue today—deposit insurance. The study deals with savings and loan association failures and the cost of their failures. There is a tradeoff between supervising control over the assets in which savings and loans and banks can invest and the risks that those assets impose upon the deposit insurance agencies and constraints on the insurance coverage; that is, whether the depositor should be put more at risk in the form of haircuts, uninsured depositors should not be paid off should a S&L or a bank fail, or other limitations of deposit insurance or other alternatives.

The study I've conducted relates to the question of the assets in which savings and loans have invested and in the way those assets have been funded, by brokered deposits and so forth, as these related to the failure of those S&L's.

And I think the results that I have come up with, I hope, will be of interest to the committee and will be helpful in terms of the issues about you are concerned.

Essentially, I looked at all of the savings and loans that failed between January 1, 1981 and August 31, 1985. I should say, when I say all that had failed, 202 total, all that the Federal Savings & Loan Corporation has declared as failures. There's reason to believe that hundreds more have failed but they haven't declared as failures. Some of them are still operating. Others may have had mergers that were not announced as supervisory mergers.

The data that I looked at are somewhat biased, in the following sense. An association that fails because of credit risks is recognized as a failure. That is, if the loans went bad, if the investments in which they were putting their funds went bad, the accountants make an entry on the books at that time actually reducing the equity, showing a loss, reducing the assets.

At that point, the association has negative equity; it has to be collapsed. On the other hand, if the association has experienced credit risk losses—that is to say, interest rates went up and the market value of their mortgages and loans went down as a consequence—those aren't recognized until they actually sell the loan.

So, for example, I have a 6-percent loan on my home bank. They carry that loan at 100 cents on the dollar, although I think they would be very pleased if I would move from Rochester and pay it off. But it's not worth 100 cents on the dollar, clearly. And, yet, it is not recognized on the books as anything more than face value.

Chairman **St Germain**. You say it's not worth a hundred cents on the dollar? The remaining balance on the mortgage?

Mr. **Benston**. That's right. Because the——

Chairman St Germain. Well, would you enlighten at least this member as to what you mean by that?

Mr. Benston. Yes. If you would wish to purchase from the bank that I have my mortgage the remaining $20,000 or so on my mortgage, I think they'd be very pleased to sell it to you for $15,000. That's what I mean.

If they sold that on the market, they couldn't get more than about $15,000.

Chairman St Germain. Yes, but until such time as they sell it, it's still worth a hundred cents on the dollar.

Mr. Benston. No, it isn't. It's not worth a hundred cents on the dollar any more than anything is worth what was paid for it. For example, I have a car that I bought in 1978 that I'm still driving. It's not worth what I paid for it, because it's gone down in value because of depreciation. The fact that I haven't sold it doesn't mean that it's worth what I paid for it.

The fact that the bank hasn't sold the mortgage doesn't mean that it's worth what I borrowed——

Chairman St Germain. I don't want to continue to—but the fact of the matter is that you are comparing a car with a mortgage. Now I am talking about the mortgage, not the house, but, the mortgage, and the balance due on the mortgage.

Mr. Benston. The balance due on the mortgage is worth the present value of the amount of cash they can expect to get over the life of that mortgage.

Chairman St Germain. Yes, but until they sell it, they can carry it on the books——

Mr. Benston. They can.

Chairman St Germain. At the actual amount. And that's not—is there any problem with that type of accounting?

Mr. Benston. Yes. It does not reflect the economic situation.

Chairman St Germain. Because it's not market value.

Mr. Benston. It's not market value, that's correct.

It's a real loss. The fact that an accountant hasn't made an entry doesn't change it from being a loss. It just changes it as being recognized as a loss.

Now, the consequence of that situation is that a bank or a savings and loan could have negative equity and still continue to operate. And that can be a risky situation for the deposit insurance funds because the temptation of management in those situations to take big risks is quite high. They're dead anyway. They might as well, you know, throw the big pass and hope it works.

So there's a real economic loss that just simply doesn't have to be recognized until, eventually, they bleed to death. That is, until the fact that they're paying more for their money than they're getting on the interest on the mortgages that they have on the books is such that it eats away their equity and they finally have to be recognized as being dead.

Sometimes, that takes a long time. We have an association in my area that may be $2 billion in the hole, but it's still operating.

And that's a real economic loss. Now, I only mention that because the study that I've done necessarily uses data from what has been reported; namely, we have failures that have been recognized as failures, which means I understated or underrepresented the associations that have failed because of interest rate problems, as against those who have failed because of credit problems.

Now, recognizing that, I used statistical analysis to examine associations in detail for the causes of their failure, for the purposes of determining whether their investments in specific assets, in particular, direct investments—which is the actual ownership of assets by the S&L's, as compared to their lending money on other people's property—whether those were major causes or causes at all of their failure.

And to summarize very briefly, because the details are in the study, essentially I found that the direct investments were not significantly related to the failure of the savings and loans; that the failures were mostly related to the traditional credit losses.

That is to say, the cost of their funds exceeded the amount of revenue they had to the point where they eventually failed.

Some of them failed because of credit losses. That is, mortgages and loans that in fact went bad. But almost none of them, I would say, except in the possible exception of Eureka in California, that none of them failed as a consequence of direct investments. Indeed, in three-quarters to one-third—I'm sorry, two-thirds to three-quarters of the cases, the direct investments were profitable. That is, these investments reduced their losses from other operations and probably kept them afloat longer than they otherwise would have been afloat.

This is also true with respect to the payouts by the Federal Savings and Loan Insurance Corporation; except for the smaller associations, the FSLIC payouts were not at all related to the amount of direct investments the associations held for those 95 of the 202 failures for which FSLIC payouts were reported.

With reports to the smaller ones, where I did find a strong, positive relationship, it turns out the finding was due to other factors, because in those instances, in fact, the associations' direct investments were profitable. And, by chance, direct investments were associated with other factors, probably.

Chairman **St Germain**. I'm having trouble. I want to listen to you and see you but it's rather difficult to look over the photographer. I'm going to ask him to move to that side so that we can see you. We want to be hospitable to our——

Mr. **Benston**. Thank you, because I'd prefer to be responsive to you personally as well.

The bottom line on this, and I, you know, want to keep this short because I know we want to have a discussion rather than my taking too much time here, is that the major problems of the failure of the savings and loans has not been their investment in nontraditional types of activity, such as in particular direct ownership of equities and property, but is due to interest rate risk.

The problem is that they made loans at a lower interest rate than the rate at which they eventually had to borrow the money. Brokered deposits played something of a role in their funding. High rates of growth played something of a role, but not uniformly. A lot of the failures were S&L's that didn't grow at all, just bled to death.

Some of the failures were S&L's that grew at very great rates and couldn't manage it. But the conclusion I draw from that with respect to concerns that you have in these hearings is that the deposit insurance problems will not be solved at all by putting constraints on the investments and assets of savings and loan associations.

The solution rather would be to put depositors more at risk, and to close down associations that in fact have real negative equity before they can take very high risks. The regulatory authorities should monitor people who appear to be taking great risks and should step in rather quickly, rather than waiting until they have dissipated enormous sums of money, as has happened in some cases.

But the risks that could be taken are so legion that to control one aspect on the assumption that that would do the job would be a very serious oversight in terms of where the problems are.

People can fail by buying long-term Government bonds and hoping interest rates go down when in fact they go up; by making investments in interest rate futures and selling contracts and losing large sums of money in the hope, of course, of making other large sums; by making very bad loans with big upfront fees that they can book to show their equity as being higher than it really is. And these are loans, not direct investment; even though they may have zero equity, they still are loans. And by doing other things that in fact can cause risks in the hope of success, when in fact it turns out badly.

But if the regulatory authorities constrain specific kinds of assets, such as the Federal home loan bank's rule on direct investments, we'll end up effectively by throwing the baby out with the bathwater.

And I'm told my——

Chairman **St Germain**. Go ahead, I interrupted you.

Mr. **Benston**. Well, I'll try to wind up because I do know you want to hear from others as well.

The essential point is that the home loan bank's regulations on direct investments, I think, have been misguided. They thought perhaps they were solving a problem. They pointed to Empire Savings & Loan as the kind of problem they had. Empire Savings & Loan had no direct investment, or virtually none.

The major failures, almost all the failures, had very little in the way of direct investment. Sam Moreno in Eureka were exceptions to this.

The basic problem is—there are others. I have spoken to some of the people who will be testifying in terms of what they're going to say, so that I didn't overlap them. At least I expect that I will agree with what Bob Eisenbeis and Tom Huertas are going to say. I think that where they see the solutions is where I would also see them.

So rather than try to say the same things that I understand they're going to say, I'll just say that I probably agree with them in terms of where the solutions are. I say probably because you never know what your colleague is going to do to you.

Chairman **St Germain**. You're saying that—let's go to Financial Corp. of America.

Mr. **Benston**. Yes.

Chairman **St Germain**. You had no problem with their having invested in or attempted to take over share in American Express?

Mr. **Benston**. No, I don't have any problem with that as such. I have a much bigger problem, I think, with the risks that they have taken, by investing in mortgage backed bonds and investing in securities in the expectation that——

Chairman **St Germain**. Isn't that a security?

Mr. **Benston**. Yes. No, when I say securities—I'm sorry, I wasn't clear. I meant not equities but bonds. Junk bonds in some cases. Long-term Government bonds, which are very secure—you can't lose your money by default.

Chairman **St Germain**. Do the junk bonds bother you?

Mr. **Benston**. What bothers me basically is not the specific things in which they invest, because I think there are so many ways that S&L's or banks could take risks that there's no way that the regulators or the Congress can stop that.

But they can stop the incentives for them to take excessive risks.

Chairman **St Germain**. But, basically, this Member, who has been here a few years, has been portrayed in the press, and correctly so, as one who has had a leaning toward the thrifts. The reason for that is the fact that for many, many years, thrifts were primarily engaged in the business of providing mortgage financing to the American people.

That was the reason for creating the S&L's in the first place. Do you recall that?

Mr. **Benston**. Yes.

Chairman **St Germain**. Now, I wish, when you give me your testimony and all of your studies, bless you, they're wonderful, that you wouldn't lose sight of the primary mission of the S&L's, and that is to provide housing.

Now, under the Garn-St Germain Act of 1982, and previous to that, we allowed thrifts to go into limited commercial lending. Limited. A percentage of assets. Correct? You're aware of that?

Mr. **Benston**. Yes. Oh, yes, I am.

Chairman **St Germain**. Because we felt that they needed that assistance in view of the dramatic rise in interest rates and the high percentage of mortgages in their portfolios, which were similar to yours at 6 percent and mine at 6 percent on my primary home, because we bought them years ago and we're not about to pay them off ahead of time.

Mr. **Benston**. Yes. One of my favorite charities is not my local bank. [Laughter.]

Chairman **St Germain**. What I want to convey to you is that we're looking at the problems of the insurance fund. We're looking at how we can assist the insuring funds and, by the same token, if we're going to have FSLIC on the one hand and the FDIC on the other hand, we're looking at them as well. They're separate because FSLIC insures the S&L industry, whose primary mission has been, and we hope will continue to be, home mortgage financing.

So when you say that you have no problem with their investing in all sorts, direct investments in all sorts, of areas other than home mortgage financing, that bothers and troubles me.

Mr. **Benston**. Let me suggest, Mr. Chairman, that most of the direct investments are very much real estate and housing related.

We have occasional statements made about windmills and race horses and things. Those are trivial, and they are almost nothing. Almost all the direct investments are in terms of building housing projects.

Chairman **St Germain**. But the potential is there.

Mr. **Benston**. But the problem is——

Chairman **St Germain**. Yes. Now, when you say direct investment, are you saying that you have no problem with there being an actual participant?

Mr. **Benston**. I have no problem with their being an actual builder, not a participant but the person who builds the project, who controls the project, because the only way that S&L's can get out of their—I am sorry, I shouldn't say the only way at all—one way that many S&L's can get out of their dilemma is by using the expertise and knowledge that they have of real estate and housing.

They have been working in this area for many years. Many of them are very, very good at it, and the question that they have is why should they be continually allowing others to do the projects and making the profits when they are very capable of doing that.

We are talking about housing projects, building projects, and that is what most direct investments are all about.

Chairman **St Germain**. Yes.

Mr. **Wylie**. Would the Chairman yield on that point?

Chairman **St Germain**. Yes.

Mr. **Wylie**. In California, Texas, and I think Florida the S&L's do have the capacity to invest in other things other than housing.

Would you suggest that if a California S&L invested in a fast food chain that that should be an insured risk?

Mr. **Benston**. Well, it is not the risk that is insured; it is the deposits that are insured.

I don't mean to be pedantic solely. I guess as a pedant I tend to be pedantic.

But I think that that is almost a red herring, if I may say, because the question comes up should they be able to invest in a fast food chain, and in some ways my reaction would be—since I know very few of the investments are in that area—I am tempted to say, no, they shouldn't, but they should be allowed to invest in housing projects, and so on.

Mr. **Wylie**. Well, that was just an example that I was using there.

Mr. **Benston**. It is just that I think that——

Mr. **Wylie**. I mean, the chairman points out we did set up a thrift institution industry to promote housing, and so forth, but the fact of the matter is that there are some S&L's which are exposing, I think, the depositors' accounts—not really exposing the depositors because the Federal Government or FSLIC is going to come to the rescue.

But is that the risk that the FSLIC funds should take or the Federal Government should take?

Mr. **Benston**. I think the FSLIC would be more at risk if they prevented savings and loans from making those investments because the alternative is that they bleed to death by not having sufficient income to cover their expenses.

Mr. WYLIE. Well, I thought that is what you were saying, but I just wanted to be sure.

Mr. BENSTON. May I say, Mr. Chairman, I can relate to your mortgage and the market value of it. The lending institution with which I have a mortgage offered to discount my loan if I want to pay it off ahead of time. I decided that I would keep the loan. [Laughter.]

[The prepared statement of Mr. Benston follows:]

Investments by and the Failure of Savings and Loan Associations
An Analysis with Particular Concern for Direct Investments and Nonmortgage Loans

by

George J. Benston*

(Professor of Accounting, Economics and Finance,
Graduate School of Management, University of Rochester)

Presented to the U.S. House of Representatives
Committee on Banking, Finance and Urban Affairs
Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance of the
Committee on Banking, Finance and Urban Affairs

October 2, 1985

Introduction and Summary

The 1980s have seen the failure of the largest number of savings and loan associations in U.S. history since the 1930s Great Depression. This period also is notable for the removal of some regulations on the operations of thrifts and commercial banks. The most important deregulatory actions have been the lifting of ceiling rates on time and savings deposits, federal permission for thrifts to offer consumer and commercial loans, and state permission for thrifts to engage in direct investments -- the ownership by an S&L of land held for development, housing and other building projects, and equity in service corporations.

In 1985 the Federal Home Loan Bank Board enacted regulations restricting the direct investments that state-chartered S&Ls can make. The FHLBB asserts that many S&L failures are the result of the failed associations having misused their state-granted powers. Others have been concerned that deregulation of interest rates and thrifts' authority to make nonmortgage loans is responsible for the failures. These concerns are examined in a study of all 202 S&Ls that failed between January 1, 1981 and August 31, 1985.

The study finds that the FHLBB's concerns about direct investments are misplaced. While higher interest rates on deposits and borrowed money have been an important cause of the failure of S&Ls, contrary to many public statements made by the FHLBB, direct investments have not played this role. Nor have higher FSLIC payouts been required for failed S&Ls that made direct investments. Rather, these investments served to strengthen the financial condition of thrifts by allowing them to earn increased profits and by decreasing the vulnerability of their portfolios to interest rate risk. The study also shows that the authority granted to S&Ls to make consumer and commercial loans has not resulted in or exacerbated failures.

The Study--Basic Definitions

Data from the financial reports of the 202 failures filed with the FHLBB for the calendar year before failure and the year before that were compared with data from 808 "peer" S&Ls that did not fail. The peer associations are similar in asset size and located in the same region of the country (five regions) as the failures. (The peers are the next two associations in the region with greater and smaller amounts of total assets and no net worth certificates.) Each year, 1981-1985, was studied individually because the FHLBB claims that the reasons for failures have changed since about 1983. Before then, it says, the cause was the unexpected increase in interest rates. The 1984-85 failures, the FHLBB asserts, are due to asset quality problems.

Before discussing the results, it should be pointed out that the sample of the 202 failed S&Ls would tend to lead to biased results overstating the significance of direct investment to failure. This occurs because an S&L "fails" when the FHLBB closes an association or forces it to merge with a presumably healthy institution. Many S&Ls are insolvent and have not been closed because they can pay their current expenses with borrowed cash. Most of these are institutions that hold mortgages that declined in value because they yield less than the current market rate of interest. These mortgages need not be written down to market but, instead, are carried on the books at face value. Direct investments, however, must be written down to market value, and credit losses must be recognized. Thus, the 202 failures are underrepresented by S&Ls that became insolvent because they have unbalanced portfolios dominated by mortgages, but nevertheless have been allowed to continue to operate.

The definition of direct investments used in this study should be understood clearly. As reported to the FHLBB in reports filed through December 1984, direct investments include only real estate held for development, investment, and resale and equity investments in service corporation subsidiaries. (Other equities were reported together with other investments including corporate debentures and commercial paper). Until the regulations were clarified on April 30, 1985, direct investments may not have included equity participation loans and joint ventures in which the S&L had a minority interest. No separate data on these loans or on marketable securities were reported to the FHLBB until June 30, 1985. Hence, the present research and the staff research relied on by the FHLBB must be based on direct investments that are defined as assets owned by S&Ls.

Method of Analyses

The failed S&Ls were studied in four ways. First, the financial ratios of the failures were compared individually with the same ratios of the nonfailed peer associations. The data were subjected to statistical tests to determine whether the ratios of the two types of associations are likely to be equal -- that is, whether the differences between the ratios really are greater or smaller than zero. A "statistically significant" difference is indicated if there appears to be but five chances in one hundred that a number as big or small as that found actually could be equal to zero. A difference that is statistically significant does not prove that the ratio is a cause of the failure (or nonfailure); among other explanations, the variable could be associated with another factor that caused the failure and not be a cause of the failure at all. Conversely, when a statistically significant difference is not found, there is strong reason to doubt that a causal relationship exists.

The second analysis involves examining all of the ratios together to determine how each is related to failure when the effect of the other ratios is considered.

The third analysis examines the net income or losses before tax from direct investments and other operations of the failed S&Ls. The numbers for all of the associations that failed in 1984 and 1985 (through August 31) are presented to examine the contention by the FHLBB that recent failures are due to direct investments.

The fourth analysis examines the payouts by the Federal Savings and Loan Insurance Corporation (FSLIC) to the financial ratios of the 95 failed associations for which these data are available.

Findings

Comparison of Individual Financial Ratios

The one-by-one comparison of financial ratios of the 202 failures and 808 nonfailed peers, given in Table 1, shows the following (the percentages given refer to the means of the ratios; the numbers refer to the ratios presented in Table 1).

1. The failures have significantly lower net worth to total assets (1), averaging -6%. This holds for all years, and is hardly surprising.

2. Their overall returns on assets (2) are significantly lower by about 2%, due primarily to a similar negative interest rate margin in all years (3). The difference of 4% is greatest among years for the 1984 failures.

3. The lower yield is not due to lower interest earnings (4) the differences of which are small and insignificant, but to significantly higher cost of funds (6) in all years, averaging 0.8%.

4. The percentage of large liabilities (borrowed funds and deposits over $100,000) to earning assets (7) is

significantly greater at the failed associations by an average of 20%. The mean difference ranges between 16% and 26% among the years. The failed associations' higher cost of funds appears due to these types of borrowing. Jumbo (over $100,000) certificates of deposit (CDs) (8) are significantly higher by 11% on average, and advances from the Federal Home Loan banks are significantly higher by an average of 7% (9). Brokered deposits (10) are higher at the 1985 and 1984 failures, by 12% and 15%.

5. Higher amounts of foreclosed real estate as a ratio of foreclosed plus outstanding loans (11) were reported by the failed S&Ls, in all years but particularly for the 1984 and 1985 failures. (The differences were 0.7% for each of the earlier years, 1.9% for 1984, and 2.7% for 1985.) The 1983 and 1984 failures also had significantly higher amounts of nonresidential mortgages (12) of 3% and 7%. Thus losses on traditional S&L investments appear positively associated with failure.

6. The failed S&Ls did not have significantly higher relative amounts of nonmortgage commercial (13) or consumer loans (14), which indicates that expanded lending powers are not associated with failure. The levels in terms of total loans were quite low -- 1% for nonmortgage loans and 5% for consumer loans.

7. Direct investments as a percentage of total assets (15) were statistically significantly higher by 1% at the 1981-1983 failures; these investments were higher at the 1984 and 1985 failures by 3%, but this amount is not significantly greater than zero.

8. Adjustable rate mortgages held by the 1985 failures (the prior year was the first for which these data were available) were almost the same proportion of total mortgages -- 27% -- as those held by their peers.

9. The percentage change in total assets in the year before failure (16), perhaps surprisingly, was not higher on the average at the failed S&Ls compared to their peers. The mean difference over all years is only 2%, and there is considerable variance among and within years.

10. The change in large liabilities to earning assets (17) is significantly higher only at the 1982 and 1983 failures; the change in the jumbo CD ratio (18) is significantly lower only at the 1985 failures; and there is no meaningful relationship for the change in the brokered deposits ratio (19).

11. The change in nonresidential mortgage loans to total loans is not significant. The change in direct investments to total assets is significantly greater at the 1984 failures only (and, hence, for the total).

Joint Comparison of Financial Ratios

These relationships also were analyzed together. The dependent variable is whether or not an association is a failure or a peer. In such analyses, the possible effect of collinearity must be considered. Two independent variables might be so closely jointly related to the dependent variable, given the effect of the other independent variables, that they partially cancel each other out. When both independent variables are included in the regression, they might seem to be statistically insignificant although one or the other actually is significant. Therefore, regressions were run with possibly collinear variables omitted. (E.g., large liabilities to earning assets was not included in the same regression as brokered deposits to earning assets and cost of funds, the changes in the ratios were omitted, and the ratio of net worth to total assets was omitted.)

The dependent variable is a one for a failure and a zero for a nonfailed peer. The independent variables are those listed in Table 1 plus dummy variables for an association that is a state-chartered mutual and state-chartered stock. The twenty-eight 1982 failures had to be omitted from this analysis because data for 1979 (two years before their failure) that are required to compute the change-in-ratios variables were not available. Consequently, the analysis includes 176 failed and 712 nonfailed S&Ls, 870 in all.

The following variables have negative, statistically significant coefficients (one percent level except where noted) in all of the regressions, which indicates that greater values of these variables are associated with lower rates of failure:

return on assets and change in the ratio;

large liabilities to earning assets (but not the change in the ratio);

brokered deposits to earning assets (but only when the change in the ratio was included -- its coefficients are significantly positive);

consumer loans to total loans, generally at the five percent level (but not the change in the ratio, which is insignificant); and

net worth to total assets (but the coefficient of the change in the ratio is significantly positive, which is curious -- it may be associated with fraudulent income booked in the year prior to failure).

The positive and statistically significant coefficients, which indicate that the greater values of these variables are associated with higher rates of failure, are:

foreclosed loans to foreclosed plus total loans and change in the ratio;

nonmortgage commercial loans to total loans (but only when the change in the variable is omitted); and percentage change in total assets (but at the from two to ten percent level when the change-in-ratio variables are omitted).

Direct investments to total assets are not at all significantly related to failures. Over the twelve regressions, the probability that the coefficients are not different than zero averages 59%, with a low of 36% and a high of 99%. The change in the ratio similarly is not statistically significant.

Thus, these results largely confirm the univariate analysis, with two exceptions. The percentage change in assets is seen to be significantly related to failure, and direct investments are strongly unrelated to failure.

Net Income from Direct Investments and Other Operations

The role of direct investments in failures was studied further by examining the amount of net income before tax (NIBT) from direct investments and from other operations over the two years before failure. A two year period was used to reduce the effect of single-year accounting. The direct investments net income is biased downward because unrealized capital gains are not recorded at year end while unrealized capital losses are recorded, but is biased upward because interest on internal funds used often is not included as an expense. Net income from other operations is biased upward because unrealized capital losses (particularly those from interest rate increases) are not recorded.

Table 2 shows the eighteen failed S&Ls (9% of the total of 202) that had direct investments of more than five percent of total assets in the year before failure. Thirteen of these (72%) reported net income from direct investments over the two years before they failed that reduced their losses from other operations by a weighted average of 31% and a simple average of 36%. (With the numbers corrected for Beverly Hills's adjustments, the averages are 24% and 31%.) Another S&L, Presidio, shows net income from direct investments that is 59% of its reported net income from other operations -- however, the positive amounts for its other operations are of doubtful validity. Three (17%) S&Ls reported net losses from direct investments that were 3%, 9%, and 13% of the net income from other operations. The 1984 figures of one of these, San Marino, change its net income from other operations to a loss, and direct investment loss from 13% of net income to 6% of net loss from other operations.) The remaining S&L with direct investment loss also had loss from other operations; direct investments increased this loss by 14%.

Eight of the failed S&Ls (4%) had direct investments to total assets exceeding ten percent. Only one of these (San Marino) had net losses from direct investments. These losses are 13% or 6% of its reported or corrected net income from other operations.

To make sure that a negative effect of direct investments was not missed, an additional test was conducted by examining all failures that showed a ratio of NIBT from direct investments to NIBT from other sources (averaged over the two years before their failure) that exceeded ten percent. Seventeen S&Ls (8% of the total) met this criterion. Of these, twelve (71%) had net income from direct investments. Eleven of the twelve had losses from other operations which were reduced by direct investment net income by a simple average of 31% and a weighted average of 20%, and the other reported net income from other operations that was increased by 20%. For the remaining five S&Ls (29%), losses on direct investments increased losses from other operations by a simple average of 30% and a weighted average of 26% (including Eureka with 63%, for which NIBT from direct investments is 39% of its total losses). With the possible exception of Eureka, the negative impact of direct investment losses clearly was insufficient to have caused the failure of the five S&Ls. The other twelve benefited from direct investments, though the benefit was insufficient to prevent their failure.

Some details on the twenty-seven 1984 failures and twenty-two 1985 failures are given in Tables 3 and 4 to examine the assertion by FHLBB Chairman Edwin Gray in testimony before the Senate Committee on Banking, Housing, Urban Affairs on July 25, 1985 (and possibly before this Committee). In his Senate testimony (p.3), he said:

> I began to warn, in Congressional testimony and in speeches to industry groups in late 1983 and throughout 1984 and beyond, that excessive risktaking was occurring at too many institutions and that this was leading inexorably to more and very expensive bad asset cases.

It is not clear whether Mr. Gray is referring to bad loans or to bad direct investments. If the reference is to direct investments, the problem about which he warned in 1983 should be seen in the S&Ls that failed in 1984 and 1985.

Only six of the forty-nine failures (12%) experienced net losses on direct investments. These losses increased three of the six failed S&Ls' losses from other operations by 9%, 8% and 63%. Two of the six had gains on other operations that direct investment losses reduced by 9% and 3%. The remaining S&L, San Marino, reported net income from other operations of $7.0 million and net losses from direct investments of $0.9 million (reducing other operations income by 13%) for the year ended December 31, 1983. It failed in December 1984 and a financial statement for 1984 was filed. This statement revealed a total loss of $250 million, of which $0.3 million was on direct investments. If San

Marino's two year average is computed over 1984 and 1983, the direct investment loss is 6% of losses from other operations.

Among the balance of the 1984 and 1985 failures, eleven (22%) had no direct investments and an additional twelve (24%) had small percentages and reported no income or expense for two years. The other twenty (41%) had net income from direct investments. Taking account of the changes to the originally reported figures for Beverly Hills, direct investments decreased these associations' total losses from other operations by a simple average of 18% and a weighted average of 10%.

Thus, direct investments do not appear to have contributed to any of the failures (with the possible exception of Eureka, and trivially for Rhode Island and First Federal), but reduced losses from other operations in from two-thirds to three-quarters of the failures where the S&Ls had more than trivial amounts of these assets.

FSLIC Payouts

The relationship between direct investments and the amount of FSLIC payments was studied because FHLBB Chairman Gray has asserted that failed savings and loan associations with direct investments are responsible for a large portion of FSLIC losses. When failures are publicly announced, the FHLBB sometimes gives the present value of the payments that it makes to assist a merger or acquisition or to redeem insured-depositors' accounts. These amounts, ranging from zero to $350 million, were given for 95 of the 202 failures. (Where FSLIC payouts were given only in total for more than one failure, the observations could not be included because the amounts could not be allocated to an individual failure.) Because the data arise during a period of inflation, the dollar amounts were adjusted with the GNP deflator to 1984 values.

The effect of direct investments and other variables on the amount of FSLIC payouts was analyzed by regressing the payout amounts on the financial ratios described above plus the amount of total assets (because the amount is likely to be related simply to the size of the failed association). Nine sets of regressions were computed, with variables that might be collinear excluded systematically. The data also were disaggregated into forty-four S&Ls with total assets equal to or greater than $100 million (EG100mm) and fifty-one with total assets less than $100 million (LT100mm). (The previously discussed analysis of the variables associated with failure or nonfailure were not disaggregated because the failures were matched to nonfailures by total assets, a procedure which controlled for the effect of size.)

The regressions show very insignificant coefficients for direct investments to total assets and the change in the ratio, in all regressions of the EG100mm S&Ls. Only the LT100mm regressions with the change-in-ratios variables omitted show statistically significant, positive coefficients for direct investments to total assets. However, an examination of the individual failures reveals that only four of the fifty-one (6%) had net losses on direct investments. Direct investments as a percentage of total assets (DI/TA), net income on losses from direct investments (DI), net income on losses from other operations (Other), DI as a percentage of other (DI/Other), and FSLIC payouts (FSLIC) for each of the four and for three other S&Ls with the highest DI/TA percentages are as follows:

DI/TA	DI	Other	DI/Other	FSLIC
0.5%	$ -52M	$-47,728	0.1	$165,000M
0.8	-40	-1,081	3.7	0
1.6	-3	-1,997	0.2	5,200
4.3	-24	-1,454	1.7	8,844
3.7	1,195	-888	-8.9	18,544
10.1	189	-2,367	-8.0	3,700
13.1	220	-656	-33.5	13,635

($ in thousands)

Thus, it seems unlikely that the significant coefficient of DI/TA is a meaningful indicator of a causal relationship between direct investments and FSLIC payouts.

Consumer loans to total loans and nonmortgage commercial loans are not significantly related to FSLIC payouts in any of the twenty-seven regressions. Foreclosed loans to foreclosed plus outstanding loans is significant in all the GT100mm regressions save one, and brokered deposits to earning assets and the change in the ratio have statistically significantly coefficients in the GT100mm regressions. The coefficients are positive for the ratio and negative for the change in the ratio. The percentage change in total assets shows statistically significant negative coefficients in the GT100mm regressions.

But the only variable that consistently "explains" FSLIC payouts is total assets. It is significantly and positively related to the dependent variable in almost all the regressions at the .001 level. The coefficients indicate that a $1,000,000 increase in total assets is associated with a $50,000 to $70,000 additional FSLIC payout.

Implications of the Findings

The federal and state governments' allowing savings and loan associations to make consumer and commercial loans and to invest directly in real estate and service corporations has not resulted in an increase in the numbers or the cost of failures. To the contrary, these additional powers and direct investments appear to have reduced the losses that were incurred by failed institutions. It seems likely that, if savings and loan associations had had the authority to shorten the maturity of their assets and use their comparative advantages in dealing directly with real estate rather than simply lending to others, they would have been and today would be in much less severe financial trouble. While giving S&Ls the authority to make adjustable rate mortgages (ARMs) has allowed them to reduce their interest rate risk, the fact that the failed associations had almost the same relative amounts of ARMs as their nonfailed peers indicates that these assets are not a sufficient solution to their problems.

Deregulation appears to have played a role in the failure of S&Ls only with respect to the increased cost of their funds. With deposit insurance having been increased to $100,000 per account in 1980, and with interest rate ceilings removed, it became possible for S&L managers who wanted to take risks to obtain the funds they required. Alternatively, without deregulation of interest rates, S&Ls would have experienced fund outflows as depositors sought and were offered the market rate of interest for their funds. Thus, many S&Ls faced the choice of bleeding to death or of growing and improving their portfolios of assets and services. Considering their unbalanced and overly-specialized portfolios, it seems more surprising that more S&Ls have not failed than that so many have failed. Restraining S&Ls from obtaining more balanced and profitable portfolios, as the FHLBB has attempted with its limitation on direct investments, is likely to prevent many associations from working their way out of their continuing bad situations.

The FHLBB's antipathy towards direct investments may be a result of its confusion of direct investments with equity participation loans and joint ventures, and perhaps more importantly, with bad and fraudulent loans. In its discussion of its initial regulation designed to limit direct investments ("Limitations on Direct Investments by Insured Institutions," Federal Register, Vol. 49, No. 96, May 16, 1984), the FHLBB asserted: "... there may be a substantial amount of business risk associated with real estate development ventures, as demonstrated by the losses associated with the development of the I-30 corridor in Dallas, Texas. . . ." (p.20720). Apparently, the FHLBB was referring to the failure of Empire Savings and Loan of Mesquite, Texas. But, as Table 3 shows, Empire held virtually no direct investments. It did, however, make mortgage and construction loans on property that appears to have been excessively appraised. The FHLBB's confusion also is evident in a comparison of the press reports on direct investments claimed to have been associated with recent failures in California with the actual amounts of direct investments held by these associations (shown in Table 3 and 4). These data reveal that the FHLBB's position finds no support in the available data. (Curiously, the only S&L with relatively large losses in direct investment, Eureka of San Carlos, California, has been little mentioned, perhaps because it held only 0.7 percent of its assets in direct investments.)

In summary, the financial difficulties of savings and loan associations were caused by portfolio imbalances and over-specialization. Deregulation is responsible for the failures of the 1980s only in allowing risk-prone managers to obtain funds. Direct investments, however, do not appear to be among the risks taken. Constraining these investments and otherwise limiting the ability of S&Ls to use their comparative advantages and serve their communities and customers can only worsen the situation.

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TABLE 1 (Page 1 of 3)

ANALYSIS OF FAILED SAVINGS AND LOAN ASSOCIATIONS, JANUARY 1, 1981-AUGUST 31, 1985
MEANS OF FINANCIAL RATIOS IN THE YEAR PRIOR TO FAILURE
(in percentages)

Year of Failure	all	1985	1984	1983	1982	1981
Number of associations	202	22	27	53	72	28
1. Net Worth to Total Assets (NWTA)						
Failed SLAs	-0.9	-1.5	-6.1	-1.2**	0.7	1.1
Peer SLAs	4.7	4.4	4.1	4.5	4.9	5.6
Difference	-5.6**	-5.9**	-10.2**	-5.7**	-4.2**	-4.5**
St. Dev. of Mean	0.5	1.3	2.9	0.3	0.3	0.6
2. Return on Assets (RETTA)						
Failed SLAs	-2.5**	-2.4**	-3.8**	-3.1**	-2.3**	-1.2**
Peer SLAs	-0.3	0.3	0.2	-0.7	-0.7	0.1
Difference	-2.2**	-2.7**	-4.0**	-2.4**	-1.6**	-1.3**
St. Dev. of Mean	0.2	0.9	1.1	0.2	0.2	0.3
3. Interest Margin (Net Interest Income) on Earning Assets (INTMARG)						
Failed SLAs	-1.1**	0.1	-0.4	-1.8**	-1.7**	0
Peer SLAs	0.8	1.6	1.6	0.1	0.3	1.4
Difference	-1.9**	-1.7**	-2.0**	-1.9**	-2.0**	-1.4**
St. Dev. of Mean	0.2	-0.5	0.6	0.2	0.5	0.2
4. Yield (Interest Income) on Earning Assets (YLDEA)						
Failed SLAs	10.9**	13.3**	11.3**	10.8**	10.6**	9.7**
Peer SLAs	11.0	12.5	11.8	11.2	10.8	9.7
Difference	-0.1	0.8	-0.5	-0.4	-0.2	0
St. Dev. of Mean	0.1	0.6	0.6	0.2	0.2	0.2
5. Fees to Total Loan Revenue (FEELR)						
Failed SLAs	4.5**	6.1**	7.0**	2.9**	4.1**	5.1**
Peer SLAs	3.5	6.3	4.8	2.6	3.0	3.2
Difference	1.0**	-0.2	2.2	0.3	1.1*	1.9
St. Dev. of Mean	0.3	0.6	1.3	0.3	0.6	1.0
6. Cost of Funds (COSTF)						
Failed SLAs	11.1**	11.1**	10.1**	11.7**	11.7**	9.4**
Peer SLAs	10.3	10.0	9.7	11.0	10.6	8.6
Difference	0.8**	1.1*	0.4*	0.7**	1.1*	0.8**
St. Dev. of Mean	0.2	0.5	0.2	0.1	0.5	0.1
7. Large Liabilities to Earning Assets (LLEA)						
Failed SLAs	33.1**	50.6**	41.5**	27.2**	29.2**	32.7**
Peer SLAs	13.5	24.3	15.4	11.5	12.3	10.2
Difference	19.6**	26.3**	26.1**	15.7**	16.9**	22.5**
St. Dev. of Mean	1.4	5.1	5.4	2.2	2.1	3.4

TABLE 1 (Page 2 of 3)

ANALYSIS OF FAILED SAVINGS AND LOAN ASSOCIATIONS,
JANUARY 1, 1981-AUGUST 31, 1985
MEANS OF FINANCIAL RATIOS IN THE YEAR PRIOR TO FAILURE
(in percentages)

Year of Failure	all	1985	1984	1983	1982	1981
8. Jumbo CDs to Earning Assets (JUMBOCD)						
Failed SLAs	16.6**	32.9**	27.3**	11.2**	12.4**	14.2**
Peer SLAs	6.0	13.4	8.5	5.5	4.9	3.2
Difference	10.6**	19.5**	18.8**	6.7**	7.5**	11.0**
St. Dev. of Mean	1.3	4.5	5.8	1.9	1.6	2.7
9. FHLB Advances to Earning Assets (FHLBA)						
Failed SLAs	12.7**	14.0**	12.4**	13.4**	12.2**	11.6**
Peer SLAs	5.5	6.5	4.6	5.1	5.8	5.5
Difference	7.2**	7.5**	7.8**	8.3**	6.4**	6.1**
St. Dev. of Mean	0.7	3.2	2.2	1.5	1.0	1.2
10. Brokered Deposits to Earning Asset (BROKERED)						
Failed SLAs	4.9**	19.8**	17.5**	0.7	0.6	-
Peer SLAs	1.2	7.4	2.1	0.4	0.0	-
Difference	3.7**	12.4*	15.4*	0.3	0.6	-
St. Dev. of Mean	1.1	5.4	6.1	0.4	0.3	-
11. Foreclosed Loans to Foreclosed plus Outstanding Loans (FORECLOS)						
Failed SLAs	1.5**	3.6**	2.4**	1.3*	0.9**	0.9**
Peer SLAs	0.4	0.9	0.5	0.6	0.2	0.2
Difference	1.1**	2.7*	1.9**	0.7**	0.7**	0.7*
St. Dev. of Mean	0.2	1.3	0.6	0.2	0.1	0.3
12. Nonresidential Mortgages to Total Loans (NRMTL)						
Failed SLAs	16.2**	27.8**	21.5**	16.1**	12.3**	12.0**
Peer SLAs	13.8	23.1	14.1	12.7	12.0	12.9
Difference	2.4**	4.7	7.4*	3.4*	0.3	-0.9
St. Dev. of Mean	0.9	3.9	3.0	1.5	1.2	1.8
13. Nonmortgage Commercial Loans to Total Loans (NMCLTL)						
Failed SLAs	0.6*	1.8*	2.0	0.1	0.2*	0.1
Peer SLAs	0.2	0.8	0.2	0.1	0.1	0.1
Difference	0.4	1.0	1.8	0.0	0.1	0.0
St. Dev. of Mean	0.2	0.7	1.5	0.1	0.1	0.1
14. Consumer Loans to Total Loans (CLOANTL)						
Failed SLAs	4.6**	4.6**	7.7**	4.6**	3.7**	3.8*
Peer SLAs	3.5	3.6	4.5	3.1	3.7	2.8
Difference	2.1*	1.0	3.2	1.5*	0.0	1.0
St. Dev. of Mean	0.5	1.1	2.2	0.6	0.6	1.3

· TABLE 1 (Page 3 of 3)

ANALYSIS OF FAILED SAVINGS AND LOAN ASSOCIATIONS,
JANUARY 1, 1981-AUGUST 31, 1985
MEANS OF FINANCIAL RATIOS IN THE YEAR PRIOR TO FAILURE
(in percentages)

Year of Failure	all	1985	1984	1983	1982	1981
15. Direct Investments to Total Assets (DITA)						
Failed SLAs	1.9**	5.5*	3.8*	1.1**	1.0**	1.0**
Peer SLAs	0.6	1.8	0.7	0.4	0.4	0.2
Difference	1.3**	3.7	3.1	0.7*	0.6**	0.8*
St. Dev. of Mean	0.3	2.0	1.6	0.3	0.2	0.3
16. Percentage Change in Total Assets (PCTA)						
Failed SLAs	13.4**	25.8**	42.0*	1.0	8.7**	11.7**
Peer SLAs	11.9	42.0	19.2	5.9	5.9	8.2
Difference	1.5	-16.2	22.8	-4.9*	2.8	3.5
St. Dev. of Mean	2.9	10.5	17.9	2.4	2.3	3.4
17. Change in LLEA (LLEAC)						
Failed SLAs	3.8**	-9.0	3.4	5.5**	6.6**	-
Peer SLAs	1.2	-2.7	1.0	1.6	2.0	-
Difference	2.6**	-6.3	2.4	3.9**	4.6**	-
St. Dev. of Mean	0.9	4.6	2.6	1.0	0.8	-
18. Change in JUMBOCD (JUMBOCDC)						
Failed SLAs	0.8	-14.3*	4.4	2.7*	2.7**	-
Peer SLAs	0.5	-2.9	1.1	0.8	1.2	-
Difference	0.3	-11.4*	3.3	1.9	1.5	-
St. Dev. of Mean	0.9	4.9	2.6	1.0	0.8	-
19. Change in BROKERD (BROKERDC)						
Failed SLAs	1.1*	-1.1	5.9*	0.3	0.6	-
Peer SLAs	0.2	0.2	0.6	0.3	0.0	-
Difference	0.9	-1.3	5.3	0.0	0.6	-
St. Dev. of Mean	0.6	2.7	2.8	0.2	0.3	-
20. Change in NRMTL (NRMTL)						
Failed SLAs	0.3	1.1	1.4	0.1	0.0	-
Peer SLAs	0.0	0.5	0.2	0.1	-0.1	-
Difference	0.3	0.6	1.2	0.1	0.1	-
St. Dev. of Mean	0.3	0.8	1.6	0.1	0.1	-
21. Change in DITA (DITAC)						
Failed SLAs	0.5**	1.6*	1.0*	0.2	0.2**	-
Peer SLAs	0.1	0.6	0.1	0.1	0.1	-
Difference	0.4**	1.0	0.9*	0.1	0.1	-
St. Dev. of Mean	0.1	0.7	0.4	0.1	0.1	-

** = statistically significantly different from zero at the .01 level
* = statistically significantly different from zero at the .05 level
Note: significance tests were not made for peer SLA means

TABLE 2
Associations With Direct Investments to Total Assets (DI/TA) Greater Than Five Percent

Name	Date of Failure	TA (millions $)	DI/TA	NIBT (millions $)		
				DI	Other	DI/Other
Bell, Belton, TX	8/85	$ 370	5.1%	$- 0.2	$ 6.0	- 3%*
New North Miss., Oxford, MS	8/84	115	5.5	0.4	-17.2	- 2
Palos, Palos Heights, IL	12/81	102	6.1	0.2a	- 1.3a	- 15
First Fin., Downers Grove, IL	4/82	6341	6.1	2.6	- 4.0	- 65
Central, San Diego, CA	6/85	2526	6.2	3.5	-51.1	- 7
Bell, San Mateo, CA	7/85	1958	6.4	- 3.5	37.3	- 9*
Fidelity, Baltimore, MD	4/84	151	3.0	0.1	-12.1	- 1
American Heritage, Bloomingdale, IL	8/84	273	7.0	0.1	- 3.6	- 3
Suburban, Wayne, NJ	8/83	1907	7.4	27.9	-88.9	- 31
Republic, Houston, TX	1/82	258	7.6	- 1.8	-12.5	14
Scandia, DesMoine, IA	4/84	68	10.1	0.2	- 2.4	- 8
Presidio, Portersville, CA	8/85	220	10.8	1.6	2.7b	59*
San Marino, San Marino, CA	12/84	682	12.9	- 0.9a	7.0a	- 13*
Cleveland Com., Cleveland, OH	10/83	17	13.1	0.2	- 0.7	- 29
Butterfield, Temecula, CA	8/85	831	13.2	6.8	-16.3	- 42
Beverly Hills, Beverly Hills, CA	6/85	2854	16.5	22.6	-25.3c	- 89
American, Biloxi, MS	4/84	9	41.5	0.3	- 4.0	- 8
Centennial, Guerneville, CA	8/85	316	44.5	7.7	- 4.5	-171

TA = total assets as of December 31, in millions $

NIBT = net income before tax, average of calendar year before failure and prior year

* = NIBT other >0

a = data for the year of failure averaged with the prior year as as follows:

	DI	Other	DI/Other
Palos	-0.3	-1.6	19
San Marino	-0.5	-7.9	6

b = Presidio is reported to have incurred large losses.

c = Beverly Hills 1984 NIBT from DI was reduced by $13.2 million (at most) and NIBT other by $82.2 million. These changes make DI/Other = -24.1%

Table 3
Savings and Loan Failures – 1984

name, city and state (listed in order of failure date)	TA (mill. $) Dec 83	TA % change 83/82	TA % change 82/81	DI/TA %	NIBT avg 83+82 (million $) DI	NIBT avg 83+82 (million $) Other	DI/Other %	ARM/TM %
FSLIC-ASSISTED ACQUISITIONS AND MERGERS								
Home, Norwalk CN	77	68	72	0.0		-2.0		15
First Fed, Grand Forks ND	259	-4	3	3.1	-1.1	-12.9	9	3
Scandia, Des Moines IO	68	-2	-6	10.1	0.2	-2.4	-8	0
Investors Sav., Houston TX	32	-7	-6	0.0		-1.9		0
American, Dededo Guam	61	12	2	0.0		-1.8		9
Windom, Windom MN	48	-3	7	1.6	0.0	-2.0	0	17
Queen City, Seattle WA	223	13	34	4.0	0.9	-3.7	-24	3
New North Miss, Oxford MS	115	76	28	5.5	0.4	-17.2	-2	2
Century of LI, Cedarhurst NY	734	-2	-2	6.4	0.3	-25.3	-1	0
Fidelity, Baltimore MD	151	-11	2	3.0	0.1	-12.1	-1	1
Amer Heritage, Bloomington IL	273	16	19	7.0	0.1	-3.6	-3	1
Mitchell Home, Mitchell SD	19	-6	-3	0.6	0.0	-0.9	0	1
Union, Indianapolis IN	332	-5	-2	0.2	0.0	-10.1	0	6
Rhode Island, Providence RI	130	22	1	1.3	-0.1	-1.2	8	17
Continental, Cleveland OH	1041	0	-5	1.1	0.3	-21.0	-1	6
Fidelity, Corith MS	33	7	-3	0.0		-0.8		6
Home, Ponce PR	52	160	20	0.0		0.0		0
Suburbia, Garden City NY	659	9	-7	0.3	0.7	-9.2	-8	9
FSLIC INSURANCE OF ACCOUNTS								
Union, Richmond VA	9	4	0	0.0		-0.1		0
Empire, Mesquite TX (a)	333	391	378	0.2	0.0	7.7	0	0
American, Biloxi MS	9	-19	167	41.5	0.3	-4.0	-8	1
Knox, Knoxville TN	166	-20	45	1.3	0.2	-3.0	-7	5
American, Knoxville TN	65	22	95	0.4	0.1	-0.5	-20	18
East Tennessee, Knoxville TN	28	12	90	0.0		0.0		0
John Sevier, Sevierville TN	41	156	87	0.3	0.0	0.0	0	3
Savannah, Savannah TN	23	65	139	4.8	0.0	-0.5	0	4
San Marino, San Marino CA (b)	682	272	205	12.9	-0.9	7.0	-13	6

TA = total assets
DI/TA = direct investments/total assets, average over 1984
NIBT = net income before tax, average of 1983 and 1982
DI = NIBT from direct investments
Other = NIBT from other sources
ARM/TM = adjustable rate mortgages/total mortgages, average over 1984

a = Empire failed in March, after loan losses were revealed that wiped out net worth of $11.7 million; none of the losses were due to direct investments.

Table 4

Savings and Loan Failures - 1985 (through August 31)

FSLIC-ASSISTED ACQUISITIONS AND MERGERS

name, city and state (listed in order of failure date)	TA (mill. $) Dec 84	TA % change 84/83	TA % change 83/82	DI/TA %	NIBT avg 84+83 (million $) DI	NIBT avg 84+83 (million $) Other	DI/Other %	ARM/TM %
Fidelity, Martins Ferry OH	73	-2	1	1.0	0.0	-1.6	0	14
People's, Honolulu, HI	15	7	7	0.0	0.0	-0.7	0	37
Capital City, Washington DC	377	18	-7	1.8	0.3	-8.2	-4	19
Northern Virg., Arlington VA	265	1	-3	2.5	0.8	-6.3	-13	7
Brighton, Brighton CO	95	-5	-2	1.0	0.0	-3.9	0	17
Century, Shawnee Mission KS	93	19	39	0.0		-0.9		25
Home, Marion OH	216	-2	-2	0.1	0.0	-16.2	0	27
Eureka, San Carlos CA	1604	18	30	0.7	-3.1	-4.9	63	40
Beverly Hills, Bev Hills CA (a)	2854	46	138	16.5	22.6	-25.3	-89	64
Southern Cal, Bev Hills CA	1510	15	19	4.3	0.3	-20.5	-1	7
Citizens, Batesville MS	15	-28	16	0.0	0.0	-1.4	0	4
Central, San Diego CA	2526	9	8	6.2	3.5	-51.1	-7	4
Sunrise, Lake Worth FL	1471	83	428	0.6	0.0	0.1	0	70
Bell, San Mateo CA (b)	1958	59	168	6.4	-3.5	37.3	-9	89
Bell, Belton, TX (c)	370	154	90	5.1	-0.2	6.0	-3	59
Butterfield, Temecula CA	831	69	391	13.2	6.8	-16.3	-42	25
Centennial, Guerneville CA	316	40	361	44.5	7.7	-4.5	-171	56
Presidio, Porterville CA (d)	220	77	204	10.8	1.6	2.7	59	0
FSLIC INSURANCE OF ACCOUNTS								
Western Com, El Cerrito CA	111	18	e	0.0	0.0	-3.8	0	27
State, Salt Lake City UT	714	5	5	4.0	0.3	-9.7	-3	27
Magnolia, Knoxville TN	5	9	-4	1.5	0.0	-0.2	0	0
Community, Nashville TN	27	38	41	0.1	0.0	-0.2	0	48

TA = total assets
DI/TA = direct investments/total assets, average over 1984
NIBT = net income before tax, average of 1984 and 1983
DI = NIBT from direct investments
Other = NIBT from other sources
ARM/TM = adjustable rate mortgages /total mortgages, average over 1984

a = Beverly Hills's 1984 NIBT from direct investments was reduced by $13.2 million (at most), and NIBT from other sources by $82.2 million. These changes make DI/Other = -9%.
b = Bell, San Mateo CA was reported to have incurred an unrecorded $60 million loss for the fourth quarter, 1984, caused mostly by bad construction loans.
c = Bell, Belton TX was reported to have incurred unrecorded losses on "speculative and possibly criminal real estate activities."
d = Presidio is reported to have incurred losses due primarily to "poorly underwritten construction loans and speculative investments in real estate joint ventures and futures and options contracts."
e = began operations in 1983.

Mr. WYLIE. Thank you.

Chairman ST GERMAIN. Now, we will hear from Professor Eisenbeis, who is professor of banking at the University of North Carolina at Chapel Hill. That is a glorious name.

Mr. EISENBEIS. It is a glorious place, too, sir.

Chairman ST GERMAIN. Going to school in the chapel, that is fantastic. [Laughter.]

Mr. EISENBEIS. Well, I have enjoyed very much being there, too, and of course Mr. Dugger went to school there, so he is quite familiar with it, too.

Chairman ST GERMAIN. He is still very religious. [Laughter.]

STATEMENT OF ROBERT A. EISENBEIS, PROFESSOR OF BANKING, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

Mr. EISENBEIS. It is a pleasure for me to be here today to discuss some of the proposals to ensure the soundness of the banking system.

Reading back through the headlines in the financial press the last couple of years would lead even the casual reader to the conclusion that the banking system is under great stress.

Small banking organizations in predominantly agricultural areas continue to fail at an alarming rate, and the FDIC now has over a thousand banks on its problem list. More banks have already failed this year than any other year since the Great Depression.

Third World loans continue to plague the balance sheets of many of our major money center banks, with few prospects for early resolution of those problems.

Even conservative estimates suggest that the FSLIC fund is seriously underfunded.

And finally, we are now facing emerging problems with the Farm Credit System, which may represent a further set of problems for the financial system as a whole.

On the other side, I think there are also some signs that suggest that the financial system is more resilient and sound than some people give it credit for. The Deposit Insurance System and the Federal Reserve, for example, have operated successfully to instill confidence in the financial system, and we have successfully avoided, so far, runs on federally insured depository institutions.

The banking system itself has proved extremely adaptable to significantly increases in both the level and volatility of interest rates that have accompanied the changes in the Federal Reserve operating procedures of October of 1979.

I don't think anyone could have guessed that the banking organizations could have survived the cost of funds that moved into the 17- to 20-percent range at a time when deposit interest rate ceilings were in the process of being phased out. And I particularly marvel at the adaptability of many of our smaller institutions.

Nonetheless, important sectors of the financial system are in great difficulty, and this has made the Congress, in particular, less sympathetic to proposals to grant banking organizations, in particular, new powers for fear that they may lead to undue risk taking and further exacerbate system stability.

In the interest of time, I would like to focus my oral comments on this particular issue. In my written statement I have also addressed the reform proposals that were raised in your letter inviting me to appear today before the committee, and that statement of course is included in the record.

I would like to point out that I think that some of these proposals represent particularly innovative responses to some of the problems that we are looking at and are worthy of careful consideration and implementation.

I have argued strongly in previous testimony and continue to believe that if banking organizations are to remain an important competitive force in financial markets then measures must be taken to ensure that they are not placed at a competitive disadvantage to less regulated firms.

This means that unnecessary and costly regulation should be removed, and I am pleased to note that we have already taken important steps in that direction. It also means that a broadening of financial powers I think is in order.

The public will have much to benefit from banking organizations offering new services when they are provided at lower cost or at greater convenience to consumers. Lower cost to consumers for financial services and lower production costs due to potential scale and scope economies translate into more efficient use of resources generally.

I recently participated in a study with Professor Benston and three other academics for the American Bankers Association of ways to ensure the stability of the banking system, and we addressed many of the issues that you raised in your letter.

Our analysis indicated that prohibitions on certain activities to banking organizations contributed to increased risk exposure and failures by limiting the potential for portfolio diversification. For example, insufficient diversification is one reason that banks in our agricultural areas are experiencing problems right now.

Thus, another important public benefit from the expansion of permissible activities may be enhanced bank safety and soundness as a result of greater diversification.

However, absent revisions in the present flat rate deposits——

Chairman **St Germain**. Mr. Eisenbeis——

Mr. **Eisenbeis**. Yes, sir.

Chairman **St Germain** [continuing]. Let me interrupt for a moment.

Mr. **Eisenbeis**. Sure.

Chairman **St Germain**. When you refer to the problems of financial institutions in the agricultural areas——

Mr. **Eisenbeis**. Right.

Chairman **St Germain** [continuing]. Isn't that as much a problem similar to that of the S&L's?

Those banks were established primarily to serve the community, the community being the agricultural community, and the lack of diversification, I submit, is as much due to geographic location as to restraints.

Mr. **Eisenbeis**. Oh, I think that is quite correct.

Chairman **St Germain**. So to use that as an example I don't think is—I would say that if I were an academic and a purist I would have a problem using that as an example. I don't think it is a pure example.

Mr. **Eisenbeis**. I think in this particular case you are correctly pointing out that there are both geographic and product dimensions to this particular problem.

The fact that these institutions were limited in their geographic capabilities to an area meant that they were going to be specialized in one particular product.

Chairman **St Germain**. But it is because they did that by choice.

Mr. **Eisenbeis**. Well, I don't think they had a lot of choice, given where they were located either.

Chairman **St Germain**. Well, I listen to the independent bankers sometimes.

Mr. **Eisenbeis**. I understand.

Chairman **St Germain**. Proceed.

Mr. **Eisenbeis**. Sure.

I think the point is that, when you have institutions that have all their eggs in one basket and you get a rotten egg in the basket, you are going to have a problem. And so that is why I think academics, in particular, tend to argue for increasing diversification, because of the ability to avoid systemic kinds of problems.

An important point I want to make in this regard is that absent revisions in the flat rate deposit insurance structure which provide incentives for increased risk taking by insured institutions, the potential risks associated with product expansion raise several issues that I think must be given careful consideration.

First, new activities may involve operations risk, especially during the startup period, not fully understood by bankers as they enter the business or by the deposit insurance agencies as they are monitoring in an attempt to assess risk.

Second, allowing nontraditional firms to enter the banking business, which seems to be a quid pro quo for expanded banking powers, only increases the chance that the FDIC will be exposed to uncontrolled affiliate risk and may be required to rescue, especially under the existing set of failure resolution policies, an increasingly wider array of firms whose primary activities are——

Chairman **St Germain**. Did you just make a very diplomatic reference to the Continental Illinois failure?

Mr. **Eisenbeis**. No; I am going to make a less diplomatic reference to that in a minute, I think.

Chairman **St Germain**. OK. [Laughter.]

Mr. **Eisenbeis**. In any case, I think we are faced with the potential that if nontraditional firms enter the industry and we have the present deposit insurance structure, there is the possibility that the deposit insurance agencies will be forced to rescue firms whose primary activities were essentially unrelated to the reasons that deposit insurance was put in place to begin with.

Finally, even if new activities are individually less risky, there is the possibility that their combination with banking organizations may facilitate greater risk taking, and whether this exposure is increased or decreased depends upon a number of factors, and these include the variability of the cash flows that come from the activities, the scale of the activities relative to the rest of the organization, and the correlation or the relationship between the cash flows from the new activity and those from those activities already being engaged in.

Thus, from the perspective of the insurance firm, it is not the riskiness of a particular activity that is relevant per se, as many seem to suggest in policy discussions on new activities, but rather what is important is what happens to the agency's risk exposure when a new activity is added to the banking organization's existing complement of activities.

For his reason, the risk implications of particular activities are firm specific and not easily generalized to make judgments that certain activities should be permitted to banks, or S&L's for that matter, and others should not.

The firm specific nature of this activity risk also suggests that from the perspective of the insurance agency the prime consideration in deciding on new activities should be the ability of the FDIC or the other regulators to assess, price, and monitor that risk.

Now, recent proposals by the FDIC and Treasury to expand the powers of banking, bankholding companies have attempted to deal with some of these issues by requiring that new activities be carried out in separate affiliates or subsidiaries. They believe that it is possible to——

Chairman **St Germain**. Excuse me, would you repeat that last phrase?

Mr. **Eisenbeis**. Yes, sir.

Chairman **St Germain**. Louder and slower.

Mr. **Eisenbeis**. Sure.

Chairman **St Germain**. It is very important.

Mr. **Eisenbeis**. Sure.

Recent proposals—is that where you mean—recent proposals by the FDIC and the Treasury to expand the powers of bankholding companies have attempted to deal with some of the problems that I have just been discussing by requiring that these new activities be carried out in separate affiliates or subsidiaries.

They believe that it is possible to partition, or divide, a banking organization into a regulated segment, which consists of the federally insured commercial banks, and a less regulated segment consisting of the parent company and its nonbanking affiliates.

The aim is to isolate and protect the bank, the insured banking entities from risk taking and other abuses and thus to limit the risks to the insurance fund flowing from the rest of the organization, which in fact would be permitted to operated in a less regulated and relatively unsupervised fashion.

As long as nonbanking affiliates are isolated by regulations, supporters of these proposals argue that no harm would befall subsidiary banks and the risks to safety and soundness could be effectively controlled.

My own view is I think this is naive. The history and review of the operations of bankholding companies indicates that they tend to operate as integrated, consolidated entities rather than as a collection of truly independent companies. In such circumstances the regulatory policies designed to isolate heavily regulated bank subsidiaries from the rest of the organization only create a set of financial incentives for the organization to circumvent those regulations and to move more and more of their activities into the less regulated side of their business.

To the integrated firm it is the total profits that are being maximized, and that are relevant to the shareholders of the bankholding company, and not necessarily the returns from separate subsidiaries and affiliates within the organization. Thus, it doesn't matter to the holding company where a particular function is being conducted as long as its contribution to the total firm profits is optimized.

This behavior response to regulation is of importance for two reasons:

First, to meet the pressures of increased competition, bankholding companies have powerful economic incentives to conduct as many of their activities as possible in the less regulated portion of their organization whenever regulations are binding and costly. Second, the shifting of activities from bank to nonbank subsidiaries may serve in the long run to increase the ties between the subsidiaries and the banking part of the organization and thus make the organization even more integrated with respect to exposure of risk than it was before.

Chairman St Germain. But, Professor, there is something I think you may have forgotten here. The proponents of this in Treasury, that fellow who is now over at the White House, said that, you know, you give them a different name, you see, the subsidiaries. Instead of being the Gotham Mammoth Bankholding Co., they then give the subsidiaries names like the Eisenbeis Securities firm and the Benston Insurance firm and the Huertas Pots & Pans Manufacturing Co.

Doesn't that solve it, by giving them different names?

Mr. Eisenbeis. I don't believe it does. They still have their financial resources tied up in those activities, and I think there is a couple of other points I am going to make in just a minute that bear upon this particular issue as well.

In any case, in terms of the way these financial incentives operate, I don't believe it's practical or possible to segment risk taking or separate the financial health of part of an organization from the whole.

Moreover, there's ample market evidence, particularly from the 1973–74 REIT experience, for example, the banking organizations will draw on the resources of an entire organization, including the subsidiary banks, to avoid the failure of an important affiliate in which they are associated, and there are ample ways for bankers to transfer resources within their organization.

The only effective way to isolate the subsidiaries would be to impose regulations that make them totally independent, as you suggest—for example, restricting name usage, and so on—to effectively make the parent a passive owner of the subsidiary. The problem with this is that it negates the basic rationale for establishing the holding company, to begin with, which is to take advantage of the beneficial synergies of financing other operational activities which may result in the benefits of conglomerations. If we go the route of isolating things so far, then, in fact, you've taken away all the incentives to engage in those activities to begin with. We give with one hand and take away with the other.

You can't cut it both ways. You can't have the benefits and take away the potential advantages from such conglomeration. And that's really the reason that I don't think that restrictions on name association is the answer. It just takes away all the benefits, partially, of engaging in a conglomerate of activity, to begin with.

My bottom line conclusion is that the way these holding companies effectively operate and the way the economic incentives are structured, requires treating them as consolidated entities and instituting the deposit insurance reforms to price risk on the basis of the consolidated entity. You have to treat these firms as consolidated firms.

In conclusion, I think the problems of financial reform facing the committee are both complex and extremely important. In our own study that we recently finished, we were struck by not only this complexity, but also how interrelated a number of these issues really are. Nevertheless, there's several policies that should be implemented to enhance safety and soundness of the banking system.

First, I continue to believe that the place to begin is reform of the deposit insurance structure and the institution of a risk base pricing system. We've got to get rid of this flat rate premium structure and the incentives for increased risk taking that go along with it.

Second, the repricing of deposit insurance would create the flexibility to expand the permissible activities of banking organizations to achieve the benefits of diversification where they may exist.

Third, analysis also suggests that the activity risk is firm specific. Thus, it's difficult to generalize that some activity should be permitted to banking organizations while generally others should be prohibited.

In this respect, the present provisions of the Bank Holding Company Act which provide that activities could be approved on a firm by firm basis, should be continued in my view.

Fourth, concerns about avoiding undue risk to the insurance funds, especially until deposit insurance mispricing has been corrected, imply that the main criteria for activity expansion, in my own view, should be related to the ability of the FDIC to assess, monitor and to price that risk.

Fifth, although I didn't discuss this in my testimony, current value accounting and reporting would be an invaluable aid to the risk assessment and monitoring process and should go hand in hand with risk-based charges for insurance.

Finally, I think that preventing the failure of large institutions and treating their depositors and creditors more favorably than those of smaller institutions, because they have more perfect Government guarantees than small banks, such as what we did in the case of Continental, is a policy that we should try to back away from. The result, I think, of this policy is to create a competitive equity that threatens the long-run viability of smaller institutions to compete and survive in the marketplace.

In addition, continuing to follow these present policies of protecting large institutions in the belief that they're too large to fail, leads ultimately to nationalization of our largest banks, such as the case we had with Continental.

Proposals to employ modified pay-offs, combined with the establishment of trustee arrangements, provide a way out of the dilemma posed by the present policies. Modified payouts are a way of treating depositors, other creditors and shareholders of both large and small institutions alike, especially when combined with a trustee arrangement, which is a device for imposing costs on the creditors of failing institutions that may be too large to resolve or liquidate promptly.

Thank you very much.

[The prepared statement of Mr. Eisenbeis follows:]

STATEMENT ON STABILITY OF THE BANKING SYSTEM: SUGGESTIONS FOR REFORM BY ROBERT A. EISENBEIS, WACHOVIA PROFESSOR OF BANKING, SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL, CHAPEL HILL, NC

It is a pleasure for me to be here today to comment on the health of the nation's banking system and to evaluate some of the suggestions for reform that have been proposed to make the system more stable. Reading back through the headlines in the financial press the past couple of years would lead even the causal reader to believe that the banking system is under extreme stress. For example, we've had the well publicized failures and problems of Continental, Sea First and Penn Square. The state sponsored insurance fund in Ohio failed and was followed shortly thereafter by the well publicized problems in Maryland and the phase out of a similar system in North Carolina. At the federal level, even conservative estimates suggest that the FSLIC fund is seriously under funded, and emergency measures are again being considered to replace previous band aids that now appear to becoming unstuck.

Furthermore, there are signs that things may not be getting better in the short run. Small banking organizations in predominately agricultural areas continue to fail at an alarming rate, and the FDIC now has over 1000 banks on its problem list. If banks continue to fail at their present rate, more will have failed this year than in any other year since the Depression. Third World loans continue to plague many of our major money center banks with few prospects for an early resolution. Finally, we are now facing emerging problems with the Farm Credit System which may represent a further unraveling of the system.

While to some, the glass may appear to be half empty, since confidence in the banking system seems to be low - there is reason to believe that the glass is more appropriately characterized as being half full. There are a number of signs that the system is more resilient and sound than many recognize. For example, our system of deposit insurance and the Federal Reserve, in its lender of last resort capacity, have jointly served to prevent runs, and a collapse such as occurred in the 1930s is not a real danger. This guarantee system has operated successfully to instill confidence in the financial system. As a result bank failures and problems continue to be viewed properly as firm-specific and isolated events. Often overlooked is the fact that we experienced in the early 1980s the worst depression since 1933, with a scant fraction of the failure of depository institutions that occurred during the Depression. Moreover, since bank failures tend to lag rather than lead economic down turns, some continuation of failures is to be expected. The banking system has also proved extremely adaptable to the radical increases in both the level and volatility of interest rates that accompanied the change in the Federal Reserve's operating procedures in October of 1979. No one could have guessed that banking organizations could have survived costs of funds that moved into the 17 to 20 percent range at a time that deposit interest rate ceilings were being phased out. I marvel at the adaptability of particularly the smaller banks during this period. While many futurists were arguing that they would fail, and that we would see a significant contraction in the banking system, most of these small institutions were bringing their noninterest operating expenses into line, streamlining operations and adopting new technologies. Instead of disappearing, many prospered. Equally interesting is that new banks have been coming into existence since 1979 at rates four to five times the number that have failed.

Nevertheless, the perception that the banking system is in great difficulty has brought forth a host of potential solutions, many of which we will discuss today. It has also brought forth a set of concerns less sympathetic to proposals for new powers for banking organizations to better enable them to compete in a deregulated environment, about which I plan to focus the bulk of my comments today. But first, I would like to offer my own assessments of the major reform proposals that are on the table today, some of which represent innovative responses to the perceived problems, while others are either impractical or misguided..

Having recently participated in a large study of ways to improve the health of the U.S. banking system with four other academicians for the American Bankers Association, we concluded that changes in the structure of deposit insurance were critical to ensuring the future safety and soundness of the system. The recurring problems in the thrift industry emphasize the potential dangers inherent in the present deposit insurance system that does not contain adequate disincentives for managers and shareholders to take on undue risks. The existing flat rate premium structure, for example, combined with the ability to issue a risk free liabilities guaranteed by the government provides great incentives for managers to take on risks, especially when their institution gets into financial difficulty. If they fail, limited liability and the existing guarantee system means that the government picks up the bill, while if they succeed shareholders and managers prosper. Insurance also removes the need for depositors to be concerned about the safety of the institutions in which they place their funds as they seek the highest returns on their monies. While most obvious in the thrift industry, the same potential problems also plague the insurance system for banks, and only serve to emphasize the need for changes in public policy.

Many of the reform proposals mentioned in the Committee's invitation to testify address these problems directly by raising the costs to owners of institutions that take excessive risks and by imposing losses on uninsured creditors of institutions that fail. Increased market discipline for excessive risk taking can take many desirable forms. Modified payoffs, reduced deposit insurance coverage, more stringent capital standards, and acceptance of subordinated debt to meet capital requirements are all designed to increase creditor vigilance. Presumably, creditors will require higher returns from more risky banking organizations or, in the case of holders of short term liabilities, simply withdraw their funds when trouble arises.

I don't know what the appropriate level of deposit insurance coverage should be. Indeed, this was one area of disagreement in our study for the American Bankers Association. Some of us favored reductions in coverage to $ 50,000 or $ 25,000 to increase market discipline while others felt that a roll back would be potentially infeasible and that, in any case, maintenance of the status quo would suffice, especially if we experienced any inflation. Still others favored 100 % insurance of at least transaction accounts. I became convinced by the arguments of my colleagues that 100% insurance was not desirable for several reasons. First, it would reduce the potential for market discipline. If an institution began taking too much risk, uninsured creditors could simple shift into insured liabilities. Second, without imposing a ceiling on the rates that could be paid, risk seeking or troubled institutions would have virtually unlimited potential to bet their institutions in an attempt to avoid a failure. The risk exposure of the insurance agencies would be difficult to limit unless significant monitoring costs were incurred. All of us found the potential costs of reimposing deposit rate ceiling too high to give serious consideration to 100% insurance. Third, 100% insurance would also provide incentives for creative redefinitions in order to convert uninsured liabilities to insured status. Finally, 100% insurance would only highten the present problems with brokered deposits, a problem we addressed in the recommendations of our study by suggesting that systemwide limits be established for aggregate insurance coverage per individual.

While imposing increased costs for greater risk is usually viewed with favor, many reformers become uneasy at the thought of market discipline that is exercised through runs on individual institutions, because they may turn into destabilizing runs on the system as a whole. However, the threat of such runs can also be a powerful restraining force on bank management if it is believed they will be permitted to run their course. One consequence of our present system of deposit insurance is that, rather than fleeing to currency at the hint of difficulties, depositors simply transfer funds from risky to less risky institutions. This recycling of funds means that runs will remain isolated events and not spread to the system as a whole (especially when the Federal Reserve facilitates the recycling of funds by providing emergency to solvent institutions but does not keep insolvent institutions afloat).

One problem with letting runs take their course is the belief that runs on certain institutions must be curtailed because they are two large to fail. Preventing the failure of large institutions or treating their creditors more favorably than those of small institutions, however, create incentives for depositors to place their funds in these large institutions because they have more perfect government guarantees than small banks. The result is to create a competitive inequity that threatens the long run ability of smaller institutions to compete and survive in the market place. In addition, continuing to follow the present policies of protecting large institutions on the belief that they are too large to let fail leads ultimately to nationalization of our largest banks, as Continental has effectively been nationalized. Proposals to employ modified payoffs, combined with the establishment of trustee arrangements, provide a way out of the dilemma posed by present policies. Modified payouts are a way of treating depositors, other creditors and shareholders of both large and small failing banks alike. The trusteeship is a device for imposing those costs on the creditors OF failing institutions that may be too large to resolve or liquidate promptly.

Risk adjusted deposit insurance premiums and risk adjusted capital standards are another important way to impose costs on risk seeking banks commensurate with the potential costs their failure may pose to the insurance funds. While often viewed as alternatives, these are really complementary approaches. The key to either is first developing acceptable methods of measuring risk. While not easy, the task is one that must be done, and is becoming easier with the trend toward securitization of assets. Whether one charges for that risk, either in the form of explicit premiums or by varying capital adequacy requirements is of lesser importance. Although I have not studied the matter in detail, I do feel there may be several reasons to favor slightly risk adjusted capital standards. Requiring high capital for more risky institutions not only imposes costs on shareholders in the form of potential lower returns on equity, but also provides a cushion against which losses may be charged while protecting the FDIC. This cushion also reduces the costs of monitoring the solvency of risky institutions. In the case of risk-adjusted premiums, there is a problem of determining how owners and managers will respond to a given premium. Two institutions with identical risk exposures may respond differently to the same premium because of different risk - return preferences of their owners. By instituting risk-adjusted capital standards, the insuring agency can assure that risky institutions provide a greater capital cushion which both protects the insurance fund and shifts more of the potential costs of failure to stockholders and uninsured creditors. Thus it may be more difficult to shift risk to the FDIC with risk adjusted capital standards than with risk adjusted premiums. This also makes insurance essentially self funding with little likelihood of drawing on federal funds in the case an institution fails.

Because there may be limited resources in the insurance funds, an important dimension in assuring the stability of the system is to assure that the public not lose confidence in the ability or resolve of the government to make good on its insurance obligations. It is for this reason, that private insurers, with limited resources and no authority to draw upon the federal government can not provide creditable guarantees for basic deposit insurance coverage. The experience in Ohio demonstrates the importance of creditable guarantees in stopping runs.

The limited resources in both the FDIC fund and FSLIC fund are disfunctional in that they serve only to create doubt in the public's mind about the willingness of the government to live up to it insurance commitments. It is interesting that the S & L industry has initiated a broad based advertising campaign publicizing that the FSLIC fund, because of the Concurrent resolution, is backed by the full faith and credit of the U.S. Government. I believe that the deposit insurance funds should be eliminated and replaced with an unconditional draw on the General Fund. In this way, insurance would, in fact, be backed by the full faith and credit of the U.S. government. I would permit, however, the regulatory agencies separately to charge for coverage, and I would permit institutions to select the regulatory agency from which they would obtain insurance. Multiple regulators would prevent one agency from being too conservative in dealing with changing markets and economic conditions and would also bring a degree of market force to bear in the setting of premiums and assessing risk.

Objections will be raised to this and similar proposals to combine the FSLIC and FDIC by bankers who tend to regard their historical contributions to the FDIC as the accumulated cash values in a life insurance policy to which they have a residual claim. Bankers don't want to see those funds used to supplement resources in the FSLIC fund in order to save the thrift industry or returned to the Treasury. What they forget is that they were never fully charged for the risks they imposed on the fund.

Moreover because mutual savings banks are insured by the FDIC, substantial liability for the problems in that industry are already being born by banks. Instead insurance was paid for by a tax levied on sized(total deposits) which went into an earmarked account; and similar to the case with term life policies, no residual claims may remain at the end of the contract period. Moreover, under the present system, charges for insurance coverage are related to the loss experience of the insurance agency, and thus healthy institutions are forced to coinsure, with the insurance fund, risk-prone institutions. With either risk adjusted insurance premiums or capital standards, however, this coinsurance element would be eliminated and charges to individual institutions would be related solely to the risks they alone posed to the insurance fund. Under this system, in addition to an improved guarantee, banks would not be required to pay for either the problems of the thrift industry or for other banks.

In times of financial stress, it is easy to call for the regulators to increased their supervisory and regulatory activities. But it is also important to pay close attention to how their scarce resources are being allocated. Traditionally, bank examination has focused primarily on evaluating of asset quality. The recent problems in the agricultural sector, however, serve to emphasize that many asset quality problems are external to banking organizations and depend upon the general health of the economy or on the health of particular sectors.

In addition, careful review of the data on failures indicates that nearly two thirds of the bank failures, and a substantially greater portion of the losses to the insurance funds result from fraud and insider dealings rather than asset quality problems. In our study for the American Bankers Association, we concluded that a refocusing of examination activities should be devoted to on site activities to detect these problems. In addition, we also argued that part of this redirection of emphasis should also included increased reliance on computerized data collection and surveillance activities as a means to detect potential problem institutions which then could be followed up with on site inspections.

While I believe I've touched on most of the issues before this committee, I would like to spend a few minutes talking about the roles of deregulation and of new powers in affecting the riskiness of the banking system. It has been argued that part of the problems facing banking organizations today stem from the rapid pace of deregulation. My own view is that this concern is misplaced. None of the major bank failures that have taken place in the last three years are directly traceable to problems arising from deregulation. Most of the large bank failures have followed from fraud and insider dealing, the lack of internal controls, insufficient diversification and just plan mismanagement. To be sure, especially in the thrift industry, the ability to pay market rates has enabled risky institutions to obtain funds that they might not have been able to attract in a world with deposit rate ceilings. But I have already argued that mispriced deposit insurance played a key roll in providing the underlying incentives to take on more risk. I would also suggest that the system would have suffered even more broadly had deposit rate ceiling been in effect during the past three or four years and the disintermediation that would have resulted been allowed to run its course.

The companion issue is that proposals to increase the potential diversification of banking organizations by expanding their powers are now viewed as conflicting with our objectives of ensuring safety and soundness. In early 1982 I testified on the Bank Holding Company Deregulation Act of 1982. That bill contained provisions to expand BHC nonbanking activities, and I argued strongly at that time, and continue to believe, that if banking organizations are to remain an important competitive force in financial markets, then measures must be taken to ensure that they are not placed at a competitive disadvantage to less regulated firms. This means that unnecessary and costly regulations should be removed and a broadening of financial powers is in order. The public will benefit from allowing banking organizations to offer new services if these activities can be provided at lower cost and/or at greater convenience to consumers. Our study indicated that prohibitions on certain activities to banks have contributed to increased risk exposure and failures by limiting portfolio diversification. Thus, an important public benefit from expansion of permissible activities may be enhanced bank safety and soundness as a result of greater diversification. Finally, our analysis also revealed that most of the reasons for restricting banking activities, though rooted in concerns for abuses and conflicts of interest, have not proved to be justified, and/or the problems have been made manageable by the imposition of other rules and regulations.

However, absent revisions in the deposit insurance premium structure, risks inherent in product expansion must be given careful consideration for three reasons. First, even if new activities are individually less risky, their combination with banking may facilitate greater risk taking. Thus, from the perspective of the insurance agency, it is not the riskiness of the activity per se that is relevant(as is suggested in most policy discussions of new activities), but rather, what happens to the agency's exposure in the entire entity when a new activity is added to the banking organization's existing complement of activities. Whether exposure is increased or decreased depends upon the variability of the cash flows from the activity, the scale of activity relative to the rest of the organization and the correlation of cash flows from the new activity with those already being conducted. This suggests that the risk concerns of particular activities ar firm-specific and not easily generalized to make judgments that certain activities should be permitted to banks while others should not. Second, new activities, especially during the startup period, may involve operations risks not fully understood by bankers as they enter the business or by the deposit insurance agencies in monitoring and assessing risk. Finally, allowing non-traditional firms into the banking business only increases the chance that the deposit insurance agency will be exposed to uncontrolled affiliate risk and be required to rescue (especially under the existing set of failure resolution policies) an increasingly wider array of firms whose primary activities are essentially unrelated to the reasons that deposit insurance was put in place.

Recent proposals to expand the powers of bank holding companies have attempted to deal with these problems by requiring that new activities be carried out in separate subsidiaries. The separate subsidiaries provision is grounded in the belief that it is possible to partition a banking organization into two components: a regulated segment consisting of federally insured affiliated banks and a less regulated segment consisting of the parent company and its nonbanking affiliates. The aim is to isolate and protect banks from risk taking and other abuses, and thus to limit deposit insurance risks flowing from the rest of the organization, which would be permitted to operate in a less regulated and relatively unsupervised fashion. As long as nonbank affiliates are isolated by regulations, supporters of the proposals argue that no harm would befall subsidiary banks and the risks to safety and soundness would be controlled. Proponents also claim that restricting new activities to separate subsidiaries can promote competitive equity since subsidiaries would be separately capitalized and presumably would be funded similarly to independent firms. Finally, equity in regulation would be facilitated by permitting regulation by function.

Such a policy is appropriate if it were truly possible to isolate banking subsidiaries from the rest of the organization. Experience, however, indicates that when activities of the parent, subsidiary banks and nonbanking affiliates are determined by centralized policies, then it becomes difficult, and indeed impossible, to isolate the insured banks from risk taking in the rest of the organization. The fact that most of the nation's money center banking organizations are dominated, both in terms of resources and management, by their bank subsidiaries makes this implicit association especially strong in the eyes of the market. Moreover, there is ample market evidence, the 1973-74 REIT experience being one of the strongest examples,that bank holding companies will draw on the resources of the entire organization, including subsidiary banks, to avoid the failure of an important affiliate with which they are associated.[1]

The history and review of the operations of bank holding companies indicate they tend to operate as integrated firms rather than a collection of truly independent companies.[2] In

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[1] Chase and Waage(1983) while arguing for the separate affiliate approach on the basis of the concept of "corporate separateness," demonstrate conclusively the economic realities and incentives for companies behaving as integrated firms. They also provide other examples of nonbanking financial firms that have bailed out troubled affiliates.

[2] See Whalen(1982a,b), Rose(1978) and Murray(1978).

such circumstances, regulatory policies designed to isolate heavily regulated bank subsidiaries from the rest of the organization only create additional incentives for the organization to attempt to circumvent banking regulations and to spin more and more activities into the less heavily regulated segments of the organization. To the integrated firm, total profits are being maximized and not necessarily the returns from separate subsidiaries. Thus it does not matter where, within the firm, a particular function is being conducted as long as its contribution to total firm profits is optimized.

This behavioral response to regulation is of importance for several reasons. First, the shifting of activities from bank to nonbank subsidiaries may serve in the long run to increase the ties between the subsidiaries and thus make the organization more of an integrated firm with respect to the exposure to risk than it was before. Second, to meet the pressures of increased competition, bank holding companies have powerful economic incentives to conduct as many of their activities as possible in the less regulated portion of their organizations whenever regulations become binding and costly. The implication is that it is neither practical nor possible to segment risk-taking or to separate the financial health of part of the organization from the whole. The only effective way to isolate subsidiaries would be to impose regulations to make them totally independent except for the passive ownership of the parent. The problem with such a policy, however, is that it would negate the basic rationale for establishing the holding company which is to take advantage of beneficial synergies of a financing or operational nature that might result from conglomeration.[3] Finally, the shifting of functions from the regulated to the less regulated segments of a holding company poses special policy problems when a parent company or its nonbank affiliates issues uninsured liabilities that are close substitutes for the insured liabilities of its subsidiary banks. As a greater and greater portion of financial liabilities shift from insured to uninsured status, the stabilizing benefits of deposit insurance are lost. Unless the insuring agencies choose either implicitly or explicitly (as was done in the Continental case) to guarantee such claims then the risks of financial crises are substantially heightened. The efficacy of deposit insurance can only be maintained by minimizing the inducements to shift funds from insured to uninsured status. This requires treating banking organizations as consolidated entities and instituting deposit insurance reforms to price for risk of the consolidated entity.

The problems of financial reform facing the committee are both complex and extremely important. In our own study for the American Bankers Association we were struck with not only this complexity but also with how interrelated the issues were. This make achieving progress on the issues more difficult because of the number of different special interests that are potentially affected. I continue to believe that the place to begin is with reform of the deposit insurance structure and institution of a risk related pricing system. I urge you to direct your efforts in that area first.

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[3] Chase and Waage(1983) argue on the basis of standard finance theory for a policy of "corporate separateness." However, standard portfolio theory, in its most simplified form, also states that absent synergies, there is no benefit to shareholders from diversification due to conglomeration. They can achieve the same benefits of diversification in their own personal portfolios.

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Chairman **St Germain**. Thank you, Professor Eisenbeis.

Now we'll hear from Thomas Huertas. I hope I'm pronouncing that name properly——

Mr. **Huertas**. Yes, sir.

Chairman **St Germain**. Who is assistant to the vice chairman of Citibank, N.A.

Now which chairman of vice do you assist? [Laughter.]

Mr. **Huertas**. Hans Angermueller.

Chairman **St Germain**. Hans Angermueller.

Mr. **Huertas**. Yes.

STATEMENT OF THOMAS F. HUERTAS, VICE PRESIDENT, CITIBANK, N.A.

Mr. **Huertas**. I'm grateful for the opportunity to testify before this committee and to present to you a summary of Citicorp's position on the reform of the deposit insurance system for commercial banks.

Congress established deposit insurance, so that the average American would not lose his savings, should a bank fail. The safety of insured deposits over the past 50 years has contributed heavily to public confidence in the banking system.

Recently, however, through episodes such as the rescue of Continental Illinois, the deposit insurance system has seemed to move significantly beyond the protection of the small depositor. This has created the impression in some quarters that the FDIC is now protecting institutions in full rather than deposits up to $100,000, and that the protection afforded large institutions is greater than the protection afforded small institutions.

If allowed to continue, protection of institutions, rather than small domestic deposits would undermine the deposit insurance system. It would weaken the market discipline that is now provided by uninsured depositors and debt holders.

It would raise the potential exposure of the FDIC, and if protection of large banks were really greater than that afforded small banks, it would be unfair to small banks and their depositors.

There are two ways to resolve whether institutions rather than small domestic deposits should be insured.

The first is to reconfirm that the sole purpose of deposit insurance is to protect the deposits of the average American.

The second is to change radically the intent of the deposit insurance system and to decree that deposit insurance should henceforth protect, not small domestic deposits, but institutions.

Citicorp strongly supports the first approach, the protection of small domestic deposits period.

Deposit insurance should not protect bank holding companies. Deposit insurance should not protect banks. Deposit insurance should not even protect all deposits. It should only protect the amount of deposits that the average American can be expected to maintain in any one bank.

And $100,000 seems to be an overestimate of that. People with more than $100,000 can and should fend for themselves.

Citicorp supports the option of the modified payoff as the best way to restrict the deposit insurance to its original mandate of protecting small domestic deposits.

The modified payoff should be the sole method for handing the disposition of a failed bank, regardless of the size of that bank.

Under the modified payoff, deposit insurance would continue to fulfill its objective of protecting small domestic deposits. Insured depositors would, as they do now, receive full and immediate access to their deposits. In addition, the modified payoff would preserve the continuity of banking service to a community. The word "modified" in "modified payoff" means that the failed bank will continue in operation under an FDIC trusteeship.

Chairman **St Germain**. Excuse me, Mr. Huertas.

Mr. **Huertas**. Yes, sir.

Chairman **St Germain**. Citibank does have some depositors who are not in the United States of America.

Mr. **Huertas**. Yes; that's correct.

Chairman **St Germain**. They are located in countries all over the oceans; right?

Mr. **Huertas**. Yes, that's right. Ninety-one other countries.

Chairman **St Germain**. Right. Now, those depositors, would you say that they should not be protected by deposit insurance?

Mr. **Huertas**. Yes, that is correct. We contend they are not protected by deposit insurance now, and they should not be protected by deposit insurance in the future.

Chairman **St Germain**. In a little while, when I'm asking my questions, I'm going to ask Mr. Eisenbeis and Mr. Benston, if they feel that those deposits should be part of the insuring fund. In other words, should they pay a premium on those deposits as well.

Proceed, Mr. Huertas.

Mr. **Huertas**. Under the modified payoff, as we said, the failed bank would continue in operation under an FDIC trusteeship, so the checks would continue to be paid and accounts would continue to be maintained, pending the liquidation of the bank or the sale of the failed bank to another bidder.

In fact, one could just as well label the modified payoff, a modified purchase and assumption transaction. But there would be one important difference from the usual purchase and assumption transaction. Uninsured depositors, debt holders and general creditors would not be made whole.

As a supplement to the modified payoff, Citicorp supports granting banks permission to use subordinated debt to meet minimum capital requirements. This would introduce another class of investors that would monitor and discipline banks.

Since subordinated debt holders would stand to lose all of their investment before uninsured depositors lost any of theirs, we would expect that the introduction of subordinated debt would strengthen the safety of deposits, facilitate the implementation of the modified payoff and reduce the exposure of the FDIC.

Together, the modified payoff and the use of subordinated debt would enhance the stability of the banking system, because it would reduce the probability of bank failure, and because it would limit the ripple effects that any bank failure could have.

Together, the modified payoff and the use of subordinated debt confirm that uninsured depositors and debt holders are at risk in the case of a bank failure. This will prompt these investors to monitor the condition of the banks in which they place their funds even more carefully than they do now. These investors will also demand higher returns on the liabilities of banks or restrict their purchases of liabilities of banks that they consider to be of above average risk. Thus investors will discipline banks that take excessive risk.

Conversely, investors will reward strong, well-managed, low-risk banks with more funds at lower cost.

Banks will respond to this stick-and-carrot type of discipline by managing their exposure to risk even more vigorously than they do now.

Under the modified payoff, banks will have an incentive to strengthen their capital and balance sheets, so as to produce consistent and growing earnings over time.

The modified payoff will also give banks a greater incentive to disclose any additional information that investors may require, in order to assess the risk of uninsured deposits or subordinated debt. Banks failing to provide sufficient information run the risk of funding at higher costs than their forthcoming competitors or not being able to fund in the market at all. Thus, there would be no need, in our opinion, for additional disclosure requirements.

In sum, the combination of the modified payoff and the use of subordinated debt will induce both investors and banks to be even more careful in assuming risk than they are now, and this will tend to reduce the probability that banks will fail.

The combination of the modified payoff and the use of subordinated debt would also reduce the possible ripple effects of a bank failure. Today regulators are concerned that letting a big bank fail would set off a panic. Regulators seem to believe that their past rescues of troubled banks have convinced a significant segment of the market that some banks are too big to fail. Regulators are apparently convinced that allowing one big bank to fail would cause the market to run from all big banks and thus destabilize the banking system. But regulators also know that rescuing a troubled big bank confirms the precedent of past bailouts, undermines market discipline and increases the likelihood of future crises. It amounts to catch 22.

The modified payoff offers a way out. It puts uninsured depositors and investors on notice that regulators do not regard every big bank as too big to fail. Investors will therefore discriminate among banks on the basis of the information available to them concerning the risk of the bank's deposits and subordinated debt. Thus the failure of one bank need not cause investors to pull their funds out of other banks. Regulators can let an insolvent big bank fail without fear of setting off a panic.

Finally, it should be stressed that the combination of the modified payoff and the use of subordinated debt assures that the FDIC will have the necessary resources to carry out its mandate of protecting small domestic deposits.

The modified payoff enables the FDIC to take full advantage of the coinsurance provided by uninsured depositors and greatly limits the amount of loss that the FDIC could be expected to sustain in the event of a bank failure. This will assure that the FDIC has the resources necessary to meet its commitment to safeguard the deposits of the average American. There would be no repetition by the FDIC of the disasters that occurred in Ohio and Maryland.

In sum, to protect the small depositor and to promote the stability of the banking system, Congress should effectively limit deposit insurance to what it was originally intended to be, an ironclad guarantee of the deposits of the average American.

In our view, the modified payoff, coupled with the use of subordinated debt to satisfy minimum capital requirements is the best way to accomplish this. Making it clear that no bank is too big to fail will enhance the stability of the banking system and permit greater competition among all financial institutions. That result is fair to banks of all sizes, fair to depositors, and fair to the FDIC.

In conclusion, I'd like to say a few words about the role that regulation should pay in deposit insurance reform.

In our opinion, the one thing that regulation should do is to insure that insolvent institutions are closed promptly. Allowing insolvent institutions to remain in operation creates perverse incentives for management. With nothing left to lose, it becomes prudent to pursue extremely risky policies. If these bets pan out, stockholders gain some equity and management keeps their jobs. If these bets don't pan out, the deposit insurance agency foots the bill.

It's a game of heads I win, tails you lose, and the sooner a stop is put to it, the better.

As for the other regulatory changes that have been proposed, such as risk-related premiums, risk-related capital requirements an increased insurance fund or the assessment of deposits at foreign branches of U.S. banks, adopting them would, I submit, be worse than doing nothing. Such reforms are not necessary, and they impose significant costs on bank customers and on banks themselves without necessarily improving the soundness of banks.

Specifically, neither risk-related premiums or risk-related capital requirements can simulate market discipline. They can only dilute and distort market discipline, for they weaken the incentive of market participants to monitor and discipline banks independently. Society can either rely on the market or on the regulator to discipline banks, and the safer choice for depositors, for the FDIC and for the banking system as a whole is, in our view, to allow the market to discipline banks.

Thank you.

[The prepared statement of Mr. Huertas with an attached paper entitled "Deposit Insurance: Overhaul or Tuneup" follows:]

STATEMENT ON

THE NEED FOR CHANGES IN THE EXISTING SYSTEM OF FEDERAL DEPOSIT INSURANCE AND DEPOSITORY INSTITUTION REGULATION AND SUPERVISION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

BY

Thomas F. Huertas
Vice President
CITIBANK, N. A.

Rayburn House Office Building
October 2, 1985
10:00 a.m.

I am grateful for the opportunity to testify before this committee and to present to you a summary of Citicorp's position on the reform of the deposit insurance system. The full statement of our position is presented in the paper, "Deposit Insurance: Overhaul or Tuneup?" which I would ask to be included in the record of these hearings.

Congress established deposit insurance so that the average American would not lose his savings, should a bank or thrift institution fail. The safety of insured deposits over the past 50 years has contributed heavily to public confidence in the banking system.

Recently, however, through episodes such as the rescue of Continental Illinois, the deposit insurance system has seemed to move significantly beyond the protection of the small depositor. This has created the impression in some quarters that the FDIC and FSLIC are now protecting institutions in full rather than deposits up to $100,000 and that the protection afforded large institutions is greater than the protection afforded small institutions.

If allowed to continue, protection of institutions rather than deposits would undermine the deposit insurance system. It would weaken the market discipline that is now provided by depositors and debtholders. It would raise the potential exposure of the FDIC and FSLIC. And, if protection of large institutions were really greater than that afforded small institutions, it would be unfair to small institutions and their depositors.

There are two ways to deal with the problems posed by the protection of institutions rather than deposits. The first is to reconfirm that the sole purpose of deposit insurance is to protect the deposits of the average American. The second is to change radically the intent of the deposit insurance system and decree that deposit insurance should henceforth protect. not deposits, but institutions.

Citicorp strongly supports the first approach -- the protection of deposits rather than institutions. Deposit insurance should not protect bank holding companies. It should not protect banks. It should not even protect all deposits. It should only protect the amount of deposits that the average American can be expected to maintain in any one bank. One hundred thousand dollars seems an overestimate of that. People with more than $100,000 can and should fend for themselves.

Citicorp supports the adoption of the modified payoff as the best way to restrict deposit insurance to its original mandate of protecting small domestic deposits. The modified payoff should be the sole method for handling the disposition of a failed bank, regardless of size.

Under the modified payoff deposit insurance would continue to fulfill its objective of protecting small domestic deposits. Insured depositors would, as they do now, receive full and immediate access to their deposits. In addition, the modified payoff would preserve the continuity of banking service to a community. The word modified in the modified pay off means that the failed bank will continue in operation under an FDIC trusteeship, so that checks would continue to be paid, and accounts would continue to be maintained pending the liquidation of the bank or the sale of the failed bank to another bidder. In fact, one could just as well label the modified payoff a modified purchase and assumption transaction. But there would be one important difference from the usual purchase and assumption transaction -- uninsured depositors, debtholders and general creditors would not be made whole.

As a supplement to the modified payoff, Citicorp supports granting banks permission to use subordinated debt to meet minimum capital requirements. This would introduce another class of investors that would monitor and discipline banks. Since subordinated debtholders would stand to lose all of their investment before uninsured depositors lost any of theirs, we would expect that the introduction of subordinated debt would strengthen the safety of deposits, facilitate the implementation of the modified payoff and reduce the exposure of the deposit insurance fund.

Together the modified payoff and the use of subordinated debt would enhance the stability of the financial system, because it would reduce the probability of bank failures and because it would limit the ripple effects that any bank failure could have, irrespective of size. Together, the modified pay-off and the use of subordinated debt confirm that uninsured depositors and debtholders are at risk in the case of bank failure. This will prompt these investors to monitor the condition of the banks in which they place their funds even more carefully than they do now. These investors will also demand higher returns on the liabilities of banks or restrict their purchases of liabilities of banks that they consider to be of above average risk. Thus, investors will discipline banks that take excessive risk. Conversely, investors will reward strong, well-managed, low-risk banks with more funds at lower cost.

Banks will respond to this discipline by managing their exposure to risk even more vigorously than they do now. Under the modified payoff banks will have an incentive to strengthen their capital and balance sheets so as to produce consistent and growing earnings over time. The modified payoff will also give banks a greater incentive to disclose any additional information that investors may require in order to assess the risk of uninsured deposits or subordinated debt. Banks failing to provide sufficient information run the risk of funding at higher rates than their more forthcoming competitors or not being able to fund in the market at all. Thus, there would be no need for additional disclosure requirements.

In sum, the combination of the modified payoff and the use of subordinated debt will induce both investors and banks to be even more careful in assuming risk than they are now, and this will tend to reduce the probability that banks will fail.

The combination of the modified payoff and the use of subordinated debt would also reduce the possible ripple effects of a bank failure. Today regulators are concerned that letting a big bank fail would set off a panic. Regulators seem to believe that their past rescues of troubled banks have convinced a significant segment of the market that some banks are too big to fail. Regulators are apparently convinced that allowing a big bank to fail would shatter the perception that all big banks are safe, cause the market to run from all big banks, and thus destabilize the banking system. But regulators also know that rescuing a troubled bank confirms the precedent of past bail-outs, undermines market discipline and increases the likelihood of future crises. It amounts to Catch-22.

The modified payoff offers a way out. It puts uninsured depositors and investors on notice that the regulators do not regard big banks as too big to fail. Investors will discriminate among banks on the basis of the information available to them concerning the risk of the bank's deposits and subordinated debt. Thus, the failure of one bank need not cause investors to pull their funds out of other banks. Regulators can let a big bank fail without fear of setting off a panic.

Finally, it should be stressed that the combination of the modified payoff and the use of subordinated debt assures that the FDIC will have the necessary resources to carry out its mandate of protecting small domestic deposits. The market approach enables the FDIC to take full advantage of the coinsurance provided by uninsured depositors and greatly limits the amount of loss that the FDIC could be expected to sustain in the event of a bank failure. This will assure that the FDIC has the resources necessary to meet its commitment to safeguard the deposits of the average American. There would be no repetition by the FDIC of the disasters that occurred in Ohio and Maryland.

In sum, to protect the small depositor and to promote the stability of the financial system, Congress should effectively limit deposit insurance to what it was originally intended to be -- an ironclad guarantee of the deposits of the average American. In our view the modified payoff, coupled with the use subordinated debt to satisfy minimum capital requirements, is the best way to accomplish this. Making it clear that no bank is too big to fail will enhance the stability of the banking system and permit greater competition among all financial institutions. That result is fair to banks of all sizes, fair to depositors and fair to the insuring agency.

In conclusion, I would like to say few words about the role that regulation should play in deposit insurance reform. In our opinion, the one thing that regulation should do is ensure that insolvent institutions are closed promptly. Allowing insolvent institutions to remain in operation creates perverse incentives for management. With nothing left to lose, it becomes prudent management to pursue extremely risky policies. If these bets pan out, stockholders regain some equity and management keeps their jobs. If these bets don't pan out, the deposit insurance agency foots the bill. It's a game of heads I win, tails you lose, and the sooner a stop is put to it, the better.

As for the other regulatory changes that have been proposed, such as risk-related premiums, risk-related capital requirements, an increased insurance fund or the assessment of deposits at foreign branches of U.S. banks, adopting them would be worse than doing nothing. Such reforms are not necessary, and they impose significant costs on bank customers and banks themselves without necessarily improving the soundness of banks. Specifically, neither risk-related premiums nor risk-related capital requirements can simulate market discipline. They can only dilute and distort market discipline, for they weaken the incentive of market participants to monitor and discipline banks independently. Society can either rely on the market or on the regulator to discipline banks. And the safer choice, for depositors, for the FDIC and for the banking system as a whole, is to allow the market to discipline banks.

Deposit Insurance: Overhaul or Tune-Up?

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CITICORP CITIBANK

Executive Summary

Does the deposit insurance system need reform? Increasingly, members of Congress, the Administration, the regulatory agencies, the deposit insurance agencies, the media, academics and bankers themselves agree that the answer is yes. But what type of reform is needed? There are a host of proposals -- the modified payoff, the use of subordinated debt to finance increased capital requirements for banks, risk-related premiums, a larger insurance fund, restrictions on brokered deposits, and a merger of the FDIC and FSLIC.

Citicorp believes that deposit insurance should not protect banks or bank holding companies. Deposit insurance should protect small deposits. Citicorp therefore supports the modified payoff approach as a means of resolving bank failures and enhancing market discipline. Under this approach, when a bank fails insured deposits will be immediately paid off in full, and uninsured depositors will receive an immediate cash payment equal to some portion (but less than 100%) of their uninsured deposits. The amount of the payment to uninsured depositors would be based upon the estimated present value of the bank's assets. Thus, the modified pay-off places uninsured depositors at risk when a bank fails. In other words, it makes the $100,000 limit on deposit insurance effective and certain. Large deposits, irrespective of the size of the bank, would remain uninsured, as would all deposits at foreign branches and all obligations of a bank's parent holding company and non-bank affiliates. Under a modified pay-off approach, deposit insurance would, in conformity with the original intent of the federal deposit insurance program, remain solely a guarantee of relatively small domestic deposits.

The modified payoff approach will promote market discipline. Banks that assume excessive risk will either pay higher rates for their funds or find it difficult to raise funds at all. Nothing concentrates the financial mind so powerfully as the possibility of loss. Remove the hint that the FDIC will bail out uninsured depositors, debtholders and general creditors, and they will monitor and discipline banks even more effectively than they do now. Return the FDIC to its original mandate of protecting the small domestic depositor, and it will be in robust condition.

The modified payoff approach should be complemented by appropriate safeguards to the payments system. To a large extent these safeguards are already in place. Restrictions on daylight overdrafts over electronic payments systems limit the impact of a bank failure on other banks and on the payments system as a whole. And as the lender of last resort the Federal Reserve has the ability to preserve the liquidity of solvent banks, and thus to preserve the payments system. What the Federal Reserve should not do is to become a lender of first or second resort to insolvent banks irrespective of size. It should commit itself to let insolvent banks fail, and, conversely, it should commit itself to lend freely to solvent but temporarily illiquid banks. But, such loans to solvent but illiquid banks should be at a penalty rate to avoid abuse of the lender of last resort facility.

With these safeguards to the payments system in place, the modified payoff approach can be applied in any bank failure, regardless of size. Thus, under a modified payoff approach no bank would be too big to fail. This is fair to banks, fair to depositors and fair to the FDIC.

Citicorp supports the proposal to use subordinated debt to meet a portion of a bank's increased capital requirements. This would further increase the market discipline provided by the modified pay-off by adding a group of investors who would further monitor the bank's activities. Indeed, to the extent that subordinated debt is added to a bank's capital structure, it supports and strengthens the safety of deposits - particularly large uninsured deposits - and reduces the risk to the FDIC.

However, Citicorp would oppose the use of subordinated debt to meet increased capital requirements as a substitute for the modified payoff approach. Use of subordinated debt as a substitute for the modified pay-off would imply that all deposits are de facto insured. Such complete de facto insurance coverage would eliminate the considerable depositor discipline that currently exists, even after the failure of Continental Illinois. Moreover, providing 100% de facto deposit insurance would significantly raise the risk to the insurance fund without providing additional protection to the average American, whose deposits are already fully insured de jure.

Citicorp would also oppose any suggestion that increased capital requirements be placed on bank holding companies. In our opinion, one of the greatest strengths of the current FDIC proposal for the use of subordinated debt is that it implicitly recognizes the distinction between banks and bank holding companies. Some deposits are insured, and it is entirely appropriate that these insured deposits be backed by assets and capital sufficient to minimize the risk of loss to the FDIC. Bank holding companies, on the other hand, are investors in banks; they should be free to determine their own capital structure. The market effectively monitors and disciplines bank holding companies now. This should be permitted to continue.

Citicorp opposes the other proposed reforms because they would reduce the efficiency of the banking system, politicize the credit process and possibly lead to credit controls. Along with the extension of insurance coverage to all deposits, the other reforms would be a long step toward the nationalization of the banking function, for they would inevitably require the insurance agencies to become involved in rating and pricing each of the risks that banks assume. Finally, each of the other proposed reforms would distort the banking system without necessarily improving the soundness of banks. Moreover, each of these proposals would impose significant costs on bank customers and on society at large. Specifically,

- Risk-related deposit insurance premiums have a strong appeal. In a competitive marketplace insurance should be priced according to the risk to the insurer. However, current proposals do not meet this standard. Specifically, risk-related, regulator-imposed premiums

- are not priced according to the risk to the insurer. Current proposals do not recognize a major risk to the deposit insurance fund -- the reluctance of bank supervisors to close an insolvent bank. If insolvent banks are promptly closed, the FDIC experiences only minimal losses, and a minimal, flat-rate premium, such as that currently levied on domestic deposits, fully reflects the risk to the FDIC.

- are not set in a competitive marketplace. All banks that are members of the Federal Reserve System must buy deposit insurance from the FDIC; they cannot switch insurers, if they believe that the FDIC is charging excessively high premiums. Consequently, risk-related, regulator-imposed are inefficient. They substitute the judgment of the regulator for that of the market. Inevitably, political concerns will influence the premium setting process, opening the way to credit allocation.

- eliminate coinsurance, a risk-limiting feature common to competitively priced insurance. Current proposals for risk-related, regulator-imposed deposit insurance premiums implicitly assume that all deposits are insured. This significantly raises the risk to the insurer, for it eliminates coinsurance provided by uninsured depositors and removes the incentive that uninsured depositors now have to monitor banks.

o An increased insurance fund is unnecessary, since

- the size of the fund is adequate relative to the FDIC's basic, legislatively mandanted purpose - the protection of the small depositor.

- adoption of the modified payoff approach would limit potential drains on the insurance fund. Protection for the FDIC should not come from a large fund but from proper supervision of banks, from the prompt closure of insolvent banks, and from the coinsurance that is, in effect, provided by uninsured depositors.

- the means proposed for increasing the size of the fund, the assessment of the currently wholly uninsured deposits at foreign branches of U.S. banks, would raise costs of the banks and of the customers that the banks serve. Specifically, assessing deposits at foreign branches would force U.S. banks out of international banking markets, reducing the efficiency of these markets and aggravating the the already grave U.S. balance of payments situation. Moreover, deposits at foreign branches of U.S. banks predominantly fund assets booked outside the United States. Most such deposits are made by non-U.S. residents and a significant proportion of such deposits are denominated in non-U.S. currency. Assessing such foreign deposits may create an impression that some or all of them are de facto insured, although they are not insured de jure.

- Restrictions on brokered deposits

  - run the risk of compromising the real service that brokers perform: namely, increasing competition by financial institutions for funds. This raises the return that small depositors receive.

  - serve no purpose. The real problem is not brokered deposits, but the failure to close institutions with negative net worth. Allowing such institutions to continue in operation creates perverse incentives for management and shareholders to pursue extremely risky policies, including the aggressive solicitation of insured deposits at above market interest rates to the detriment of sound, well managed institutions.

- Merging the insurance funds

  - will not cure the thrift crisis. The thrift industry is a perfect example of the danger of over-regulation. By boxing the thrifts into long-term fixed-rate mortgages funded with short-term variable rate deposits regulation induced thrifts to take massive interest rate risk. Failure to close thrifts promptly when their net worth became negative induced some thrifts to acquire high-yielding, risky assets, frequently funded by insured high rate deposits, that ultimately produced further losses and added further to the drain on the FSLIC. Merging the insurance funds does not address this problem. It merely passes the burden to a sound commercial banking system. The thrift crisis must be resolved directly.

In sum, Citicorp believes that the deposit insurance system needs reform, and that a market-oriented approach (modified payoff supplemented by the limited use of subordinated debt) offers the best prospect for improvement. In combination, these two reforms would enhance market discipline, while other proposed reforms would increase bank regulation and thereby weaken market discipline. Thus, the market approach is preferable. Moreover, the market approach would ensure that no bank is too big to fail and that deposit insurance remains what Congress intended it to be: an ironclad guarantee of the deposits of the average American.

7/30/85

Home State Savings. Continental Illinois. Penn Square ... Is the financial system falling apart? Does the deposit insurance system need a complete overhaul?

No, the financial system is sound, and the federal deposit insurance system is working well. The past five years have been the most turbulent economic times since the Great Depression. Inflation and disinflation, recession, volatile interest and exchange rates, and sharp swings in the fortunes of various sectors, notably energy and agriculture, adversely affected borrowers and the banks that lent them money. In such stormy economic weather some banks were bound to fail.

But relatively few banks have actually failed, and the failure of these banks has not led to the kind of catastrophe associated with bank failures before the creation of the FDIC.[1] Small depositors are fully protected, and communities, by and large, are spared major disruption. The burden of bank failure falls where it should. Management is fired, shareholders suffer capital losses, and large depositors may or may not have immediate access to all their deposits. But the banking system remains intact.

Although the system works well, a tune-up could make it work better. The failure to close banks with negative net worth and the bail-out of troubled big banks, such as First Pennsylvania in 1980 and Continental Illinois in 1984, threaten to undermine one reason why the deposit insurance system has worked so well. They threaten to dilute the discipline that uninsured depositors exert over risk taking by bank management.

In response, some would propose to abandon depositor discipline entirely, and to place new regulatory controls on banks. Citicorp opposes that position. The proposed controls are neither necessary nor sound; they would only increase costs for banks and their customers. Citicorp believes that, if the deposit insurance system is to be reformed, market discipline should be maintained and strengthened. This paper explains why.

I. The Deposit Insurance System Works Well.

Deposit insurance is not insurance in the ordinary sense of the word. It is a financial guarantee. It was established in 1933 to restore confidence in the banking system. Bank regulation and the Federal Reserve, as lender of last resort, had not prevented the failure of individual banks and the spread of bank failures during the Depression. Deposit insurance was instituted as a safety net for the small and presumably unsophisticated depositor. Deposit insurance meant that the small depositor would not lose his money, even if bank supervisors and the lender of last resort did not prevent the failure of a bank.

Today deposit insurance protects the first $100,000 of a depositor's funds at each bank in the country, a sum that probably exceeds the balance in 99% of the accounts at the nation's banks, and a sum that exceeds the total financial assets of 95% of American households.[2] Plainly, deposit insurance fully protects the deposits of practically all Americans.

Deposit insurance also promotes the stability of the banking system. Deposit insurance assures the small depositor that his funds are safe, and that the failure of one bank does not mean that all banks are in danger of failing. Deposit insurance therefore tends to make bank failures isolated events, and it eliminates the danger that unfounded rumors will start contagious bank runs. Thus, deposit insurance helps to maintain public confidence in the banking system.

However, deposit insurance may increase the risk that a bank will fail. The presence of insurance lessens the incentive of the insured to avoid the risk insured against. Thus, deposit insurance removes the incentive of the insured depositor to monitor the condition of the bank in which he places his funds. The deposits are safe no matter what happens to the bank. Hence, the insured depositor is less likely to withdraw his funds or to demand a higher return from a bank that pursues policies that are riskier than those of other banks. Thus, insured depositors exercise no discipline on banks, and deposit insurance may induce banks to take risks that they would not take, if deposits were not insured.

However, other factors hold risk-taking by banks in check. First and foremost, there is self-discipline by shareholders and management. Shareholders have the incentive to structure compensation arrangements with executives so that the executive cannot benefit at the expense of the shareholders from the risks that the firm takes. Shareholders also have the incentive to make sure that the debt and deposits issued by the bank do not pose a threat to their investment.

Management itself also has an incentive to prevent bank failure. Guiding a firm to failure is hardly the best qualification for leading another. Failure diminishes or destroys the human capital (future earning power) of the executive. It may also seriously deplete his financial capital. Most executives have a considerable portion of their net worth invested in their own corporations (through outright ownership of stock, through options to buy stock at below market prices and through pension benefits). In addition, an executive faces a loss of prestige, if he should lose his job as a result of the failure of the firm. He also faces possible civil and criminal sanctions. For the executive of a large, healthy firm, these losses may bulk large relative to the possible increases in the executive's income, wealth and prestige that would result from the firm's pursuing extremely risky policies. Thus, self-preservation is an important constraint on management risk-taking.

Regulation also affects risk-taking by banks. Bank regulation aims to ensure bank solvency, although certain aspects of regulation, such as limits on branch banking and on the activities in which banks may engage, restrict diversification and therefore increase bank risk. Bank regulation predates the introduction of deposit insurance, and takes the form of portfolio restrictions, minimum capital requirements, accounting procedures and bank examination. For example, national banks are subject to a lending limit on loans to a single borrower, to reserve requirements and to limitations on the type of assets that they can acquire or the activities in which they can directly engage. National banks also have to maintain a minimum capital and their dividend payments are restricted. National banks also have to follow accounting policies mandated by the Comptroller of the Currency and to submit periodic call reports. Finally, national banks are subject to periodic examination by the Comptroller. The examiners not only audit the bank's condition and verify that it is in compliance with bank regulations, but they also counsel banks regarding management practices and suggest ways that banks can reduce the risk of failure and loss to depositors. Ultimately, the Comptroller has the power to restrict the activities of banks found not to be in compliance with regulations or to shut down banks that he deems to be insolvent. State-chartered banks are subject to similar regulations.

Finally, the market checks risk-taking by banks. Deposit insurance does not protect large deposits. Amounts over $100,000 in domestic branches are uninsured, and these deposits are at risk if a bank fails. So are all deposits at a bank's foreign branches. Thus, the uninsured depositor has the incentive to monitor the bank in which he places his funds. Monitoring by uninsured depositors tends to discipline banks that rely on uninsured deposits for a large portion of their funds. These banks face the possibility of higher funding costs or reduced funds availability, if uninsured depositors perceive that the risk of the bank increases. In an extreme case, the bank will not be able to obtain funds at any price and it will fail. This is what was happening to Continental Illinois in early 1984.

To prevent this outcome a bank that relies heavily on uninsured deposits has the incentive to pursue policies that will yield consistent and growing earnings over time, and to disclose information about its condition that will allay uninsured depositors' concerns about the safety of their funds. Consistent and growing earnings preclude failure and safeguard depositors' funds. Accurate information enables uninsured depositors to judge the risk of the institution in which they place their funds. Refusal to provide information that uninsured depositors consider material will be interpreted as a signal that the true facts have adverse implications for the bank. With no information, uninsured

Table 1. Large Banks Rely Largely on Uninsured Deposits

Total Domestic Deposits ($ millions)	Number of Banks[a]	Uninsured Deposits/Total Deposits[a] (in percent)
5,000+	26	68.1
100–5,000	1,990	30.8
Less than 100	12,437	3.0
Total	14,453	37.6

[a] Figures refer to insured commercial banks as of June 30, 1984.

Source: DRI, Sheshunoff Data.

depositors are likely to assume the worst, and to demand a premium from the bank that keeps them in ignorance, or to refuse to place funds with that institution at all. Thus, heavy reliance on uninsured deposits will tend to push banks to adopt conservative policies and to keep depositors fully informed.

Which banks rely heavily on uninsured deposits? Essentially, the nation's largest banks do. According to statements of condition for June 30, 1984 over two-thirds of the deposits at the nation's 26 largest banks were uninsured (Table 1). In contrast, at the 1,990 banks with domestic deposits ranging from $100 million to $5 billion, uninsured deposits accounted for less than one-third of total deposits. And at the nation's smallest banks, the 12,437 banks with domestic deposits of less than $100 million, uninsured deposits were only 3% of total deposits. Thus, the larger the bank, the more discipline the market can be expected to exercise.[3]

Market Discipline after Continental Illinois. Critics doubt that the market disciplines large banks, especially in the wake of Continental Illinois and Comptroller of the Currency's C. Todd Conover's statement that some banks are 'too big to fail.'[4] There is no evidence, however, that the markets believe Mr. Conover. If the markets were convinced that the liabilities of large banks are guaranteed, and if this guarantee were of prime importance to investors, then all large banks should have no trouble raising funds and all like obligations of large banks should trade at the same rates. But this is not what the data show. The market continues to discipline large banks, either by restricting the volume of funds that a bank can raise at a given rate or by raising the rate that a bank must pay for funds.

7/30/85

Uninsured depositors discipline banks principally by restricting the volume of funds that they are willing to deposit in a bank that they perceive to be riskier than its peers. Despite having an implicit government guarantee on all its deposits, Continental Illinois still cannot fund itself completely in the open market. It continues to rely on borrowings from other banks and from the Federal Reserve.[5] This indicates that potential depositors in Continental are not entirely convinced that Continental cannot fail. Moreover, in the wake of Continental Illinois, large depositors (including other banks) have stepped up their surveillance of the banks in which they place their funds.[6]

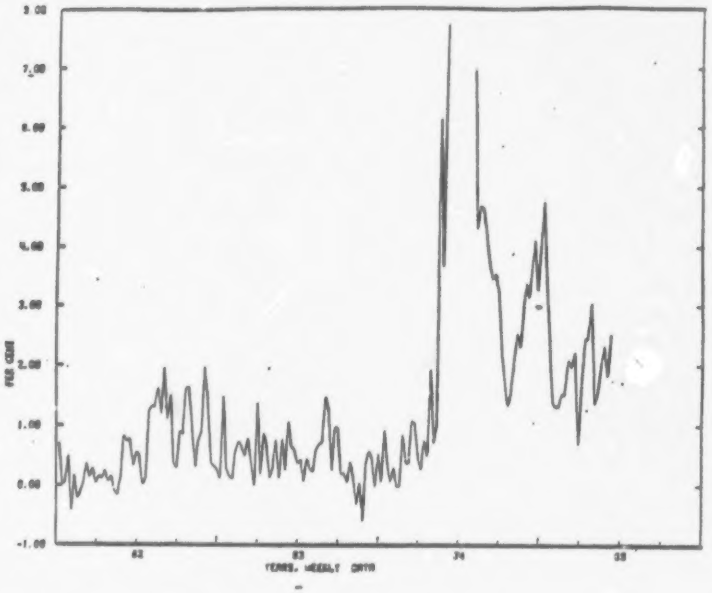
There is also some differentiation among the rates that banks pay for CDs. One would expect the CDs of the top nine banks to trade at identical rates, since these banks are allegedly "too big to fail" and since the CDs of any one of these banks are eligible for delivery against the CD futures contract on the International Money Market. However, there is a slight dispersion in the rates that these banks pay on CDs of the same denomination and maturity. Banks outside the top nine pay markedly different rates. Some banks pay lower rates. In recent months the CDs of Mellon and Wachovia have been trading at lower rates than the top nine money center banks. Other banks pay higher rates. In particular, Continental Illinois must pay a premium of one-fourth to one-half percent on its large denomination CDs.[7]

Another indicator that the market believes that not all deposits are insured is the introduction of ratings on bank CDs by the bond rating agencies of Standard and Poor's and Duff and Phelps.[8] If there were de facto 100% insurance that guaranteed the principal, interest and liquidity of all bank CDs, there would be no incentive to rate bank CDs. But if large denomination bank CDs are not insured, it makes sense for banks and investors to have them rated. A rating provides investors with an independent and on-going assessment of the risk of the bank's CD at little or no cost to investors. To develop and maintain its ratings the rating agency verifies the accuracy of the information provided by the bank and monitors the bank over time. This provides investors with relevant information and serves to curb management actions that would harm investors in a bank's CDs. Thus, a rating provides a type of market discipline.[9]

Depositor discipline is not the only type of market discipline that banks face. They also face discipline by creditors of their parent holding companies. Most banks (and all large banks) are subsidiaries of bank holding companies and rely on their parent holding companies to supply them with capital. Bank holding companies borrow in the public markets and "downstream" some or all of the proceeds to their bank and non-bank subsidiaries. Thus, if bank holding companies, as a result of increased risk, cannot raise debt in the public markets or if they must pay higher rates to holders of their debt, they will be forced to constrain the activities or limit the growth of their bank (and non-bank) subsidiaries.

As a practical matter, the yield on bank holding company debt will, to a large extent, reflect investors' perceptions of the risk of its major bank subsidiary. Bank holding companies' income consists largely of dividends and interest received from their main bank subsidiary. In fact, holders of bank holding company debt largely depend on the earnings of the bank to service the debt.

Figure 1. Risk Differential between Debt of Continental Illinois Corp. and Security Pacific Corp., January 1982 to May 1985, in percent



Source: Citquote, a Citibank N.A. data base.

Yields to maturity are calculated on the basis of weekly (Friday) closing prices on the New York Stock Exchange as collected for Citiquote by Telstat. The debt obligations compared are a $100 million, 7½ year, 8.5% note issue for Continental Illinois Corporation and a $100 million, 7½ year, 8.8% note issue for Security Pacific Corporation. Neither issue contains a call provision. The Continental Illinois issue matures November 1, 1985 and the Security Pacific issue matures December 15, 1985. Thus, for a positively sloped yield curve, such as existed during the entire period, the risk differential estimated here would understate the true risk differential.

Data on yields on bank holding company debt show that market discipline persists, even after the rescue of Continental Illinois. Considerable differences exist among the yields on bank holding company debt, indicating that the market distinguishes among bank holding companies according to risk. Again, look at Continental Illinois Corporation, the holding company for Continental Illinois Bank. Since the end of September 1984 its debt has yielded an average of 2.3% more than the debt of Security Pacific Corporation, the holding company for Security Pacific Bank (Figure 1). Moreover, this spread is considerably wider than the 0.5% spread that prevailed from the beginning of 1982 to the beginning of May 1984. In addition, the variance of the spread has considerably increased. This indicates that market discipline not only continues but has become more vigorous.

Thus, market discipline over banks takes two forms: quantity and price. Uninsured depositors discipline risky banks by withdrawing funds. Debtholders (of the bank holding company) discipline risky banks by demanding an increase in the rate that banks' parent holding companies must pay for funds.

There are two reasons for this difference in discipline: bank regulation and supervision, and the lender of last resort facility of the Federal Reserve. Bank regulation and supervision reduce the incentive of the uninsured depositor to monitor the condition of the bank in which he places his funds. Hence, bank regulations substitute for the covenants that depositors would themselves impose, if banks were not regulated. Moreover, since the regulatory authorities supervise the covenants directly and continuously at no explicit cost to depositors, depositors can depend on the judgment of the regulator. With the regulator looking over the banker's shoulder, there is less incentive for the depositor to do so.[10]

Such bank regulation and supervision significantly circumscribe the amount and type of discipline that the market can impose on banks. The regulator fulfills a function that creditors themselves or their trustee fulfill in the case of the unregulated firm. With the regulator as judge and jury of a bank's solvency and given the regulator's assumption of much of the costs of reorganizing or liquidating a failed bank, there is little incentive for the depositor to demand, as he would in the case of an unregulated firm, to be compensated in the form of a higher yield for the possibility that he may incur bankruptcy costs at some future date. What the depositor will monitor is the ability of the regulator to shut the bank when it becomes insolvent as well as the likelihood that the bank itself will become insolvent despite the regulators' best efforts to keep the bank above water.

The lender of last resort facility of the Federal Reserve also reduces the incentive of uninsured depositors to monitor the banks in which they place their funds. Since its inception in 1914 the Federal Reserve has been empowered to lend on a collateralized basis to solvent but temporarily illiquid banks. This prevents banks from failing simply because they are illiquid and limits failure to cases where banks are insolvent. Thus, the lender of last resort facility tends to reduce the risk of bank failure. This protects depositors, but dilutes depositor discipline.[11,12]

In sum, as a result of bank regulation and Federal Reserve operations, the discipline that depositors themselves impose, over and above that provided by the regulator, is likely to be of the all-or-nothing variety. Specifically, price or yield deviations among issues of bank deposits are likely to be smaller than those for the equivalent maturity debt of unregulated firms. Those banks deemed creditworthy can get funds at approximately the same rate; those that are not, cannot get funds at any rate. If a creditworthy bank loses that status, a run can develop.

In contrast, the market discipline exercised by debtholders of the parent bank holding company is more likely to take the form of raising the rate at which the bank can obtain funds. The yield on holding company debt may be a better indicator of risk in the bank than yields on bank deposits, since the holding company is not as directly supervised as the bank, since holding company debt is not as liquid as deposits, since the holding company per se does not have access to the discount window, and since there is less precedent for believing that the Federal Reserve and the FDIC would invariably bail out the holding company when aiding a distressed bank. Indeed, the variation in yields on bank holding company debt is probably a good indicator of what depositor discipline would be like in the absence of Federal Reserve guarantees and bank regulation.

In sum, market discipline persists. Large banks and bank holding companies raise the bulk of their funds in extremely competitive markets from investors who value liquidity highly. Banks and bank holding companies in these markets are constantly monitored by investors themselves and by various rating agencies, in addition to the regulatory authorities. Banks that meet the market's exacting standards of safety and liquidity can raise funds at reasonable rates. Those banks and bank holding companies which do not pass the market's muster must either pay higher rates or cannot raise funds at all. Thus, if they are to retain access to the market, banks and bank holding companies must pursue policies that will yield consistent and growing earnings over time.

Thus, the market does not believe that big banks are too big to fail. Large depositors and debtholders perceive that they are at risk; there evidently remains considerable doubt as to whether, how or when the FDIC and the Federal Reserve would come to the aid of a distressed big bank.[13] At a minimum, large depositors and debtholders must remain concerned that their funds would suddenly become inaccessible. They cannot afford to await the outcome of deliberations by the FDIC and/or the Federal Reserve. This uncertainty about the liquidity of a bank's deposits is sufficient inducement to large depositors and debtholders to monitor the condition of the banks in which they place their funds. Despite official and unofficial statements to the contrary, market discipline continues. The deposit insurance system is working well.

II. How to Make the Deposit Insurance System Work Better.

Although the deposit insurance system works well, it could be made to work better. Two problems challenge the current deposit insurance system. The first is the continuing reluctance of bank supervisors to close an insolvent bank. Allowing banks with negative net worth to continue in operation creates perverse incentives for management and shareholders. With nothing left to lose, it is rational for a bank or thrift to pursue extremely risky policies. If the bet pans out, the bank or thrift moves back into the black. Shareholders regain some equity, and management gets to keep their jobs. If the bet doesn't pan out, the bank fails and the FDIC must pick up the pieces and bear a loss that in all probability is significantly greater than the loss the FDIC would have incurred had the bank been closed or reorganized immediately after the insolvency occurred.

The second challenge to the deposit insurance system is the apparent inability of the system to allow a large bank to fail. Although Continental Illinois did not eradicate market discipline, there is no doubt that if the precedent were consistently followed for a long enough period of time, market discipline would diminish and ultimately disappear.

In response to these challenges, some changes in the deposit insurance system have been proposed. The proposed changes are to be grafted on to the existing structure of bank regulation and supervision. Taken together, the various proposals for deposit insurance reform work at cross purposes. On the one hand, there are proposals to maintain and strengthen market discipline. Large deposits would remain uninsured, and uninsured depositors would be given greater incentives to monitor and discipline banks. This would enhance competition among banks and would foster continued deregulation of the financial services industry. The banking system would be sounder and consumers would benefit from lower costs and greater convenience.

On the other hand there are proposals which seek to improve bank safety by strengthening bank regulation. In effect all deposits would be insured and regulators would be given additional tools to discipline banks. But this would impose additional costs on banks and on the customers they serve without necessarily increasing the soundness of the banking system.

7/30/85

1. Relying on the Market

For depositors to exercise discipline over banks, they must perceive themselves to be at risk in some meaningful sense. Obviously, depositors are not at risk, if all deposits are insured, or if the FDIC bails out uninsured depositors of an insolvent bank by merging it into a sound bank, or if the FDIC bails out uninsured depositors by providing the insolvent bank ongoing assistance sufficient to keep it in operation. Thus, if uninsured depositors are to be at risk, they must lose money when a bank fails.[14]

The modified payoff approach. The modified pay-off approach proposed by the FDIC accomplishes this. This market-oriented approach combines the pay-off and purchase and assumption approaches traditionally employed by the FDIC in handling bank failures. Under the pay-off the FDIC paid off insured depositors and liquidated the bank. Although this imposes losses on uninsured depositors, the pay-off eliminates the bank's franchise value and disrupts service to the local community. Under the purchase and assumption transaction, the failed bank is merged into a healthy bank. This preserves the failed bank's franchise value (the acquiring bank pays a premium for the failed bank) and preserves continuity of banking service, but imposes no losses on uninsured depositors. Thus, purchase and assumption transactions tend to undermine depositor discipline.

The mofified pay-off approach preserves both continuity of bank service and depositor discipline. Under the modified pay-off approach a failed bank would be placed in receivership under the FDIC. The FDIC would then immediately pay off the insured deposits in full, either by transferring their accounts to a healthy bank or by paying depositors directly. If the FDIC transfers the deposits, it will couple the deposits with selected non-problem assets and with the failed bank's franchise. This creates a "clean" bank that the FDIC sells to another bank at a premium, much as it currently sells the entire bank in a purchase and assumption transaction. After the sale the FDIC retains the remaining assets of the bank, and these are liquidated for the benefit of uninsured depositors and general creditors. However, the FDIC would give uninsured depositors and general creditors of a failed bank an immediate cash payment equal to some fraction of the net present value of their claim on the failed bank. They would receive subsequent cash payments as the bank was sold or liquidated. Thus, uninsured depositors would suffer significant losses as a result of a bank failure.[15] Over time this could be expected to increase the incentive of depositors to monitor and discipline the banks in which they place their funds.

The FDIC experimented briefly with this approach during early 1984, but abandoned the experiment when it came to Continental Illinois, since it was felt that the failure of such a big bank would severely disrupt the payments system. Thus, to enhance depositor discipline, it is necessary to develop a system under which a big bank could fail without disrupting the payments system.

According to the Federal Reserve, the systemic risk to the payments system from the failure of a big bank centers around the operation of large electronic payments systems and the possibility that the failure of one bank to settle could cause the failure of other banks and therefore lead to the collapse of the payments system, the disruption of domestic and international money markets and to a decline, and possibly a catastrophic decline, in output and employment at home and abroad.[16]

Currently, the prospect of a big bank failure appears to present a no-win situation to the Federal Reserve. If the market expects that the FDIC and the Federal Reserve will bail out big banks, and the Federal Reserve doesn't fulfill that expectation, then panic results. If the Federal Reserve bails out a big bank because it realizes that not bailing out the failing big bank would produce a panic, then it makes the problem worse. The bail out of a bank confirms the precedent of past bail outs and increases the expectation of market participants that the Federal Reserve will bail out the next big bank that gets into trouble. This further undermines depositor discipline and increases the probability that another emergency will occur. Thus, today's rescue becomes the seeds of tomorrow's crisis.

To break this vicious circle, the Federal Reserve and FDIC must convince the market, well in advance of a crisis, that they will not bail out the next big bank that gets into trouble. To do this the Federal Reserve and FDIC must be able to point to a plan in place that will protect the payments system in the event of a big bank failure. This would eliminate any expectation by the market that big banks will be bailed out and remove the Federal Reserve from the no-win situation that it currently believes itself to be in. [Of course, to be completely convincing, the Federal Reserve and FDIC must actually refuse to bail out big banks that get into trouble.]

Risk to the payments system centers on the impact that a bank failure would have on the continued smooth operation of the nation's electronic payments systems. Payments over these systems come in and go

Table 2. Payment System Activity, 1980

	$ trillions	%
Direct Electronic Transfer	117.2	86
FedWire	80.0	59
Chips	37.0	27
ACH	0.2	–
Indirect Paper–Based Transfers	19.1	14
Checks	19.0	14
Bank Cards	.1	–
Total	136.3	100

Source: Association of Reserve City Bankers, Report on the Payments System (Washington, D.C., 1982), p. 12.

out very rapidly and they are for very large sums. Hence, in the interval between settlements among banks, banks can extend each other very large amounts of credit. The volume of these daylight overdrafts, as they are called, poses a threat. In the event that a bank with large overdrafts on a number of banks fails before settlement and therefore cannot repay its creditor banks, these banks may also fail. This would in turn threaten the solvency of the firms that had made and received payments during the day, while thinking them good. Thus, the insolvency of one or more banks might threaten the insolvency of the major firms that use banks to make electronic transfers of funds.

How likely is this doomsday scenario, if a big bank should fail? The answer is not very likely, for there already exist safeguards in the payments system, and these are being strengthened. The first and more important concerns FedWire, the electronic transfer system operated by the Federal Reserve System, over which 59% of the nation's payments move (Table 2). If all payments moved over FedWire, the catastrophe outlined above could not occur, because the Federal Reserve in effect guarantees all payments made over FedWire. When a bank makes a transfer on behalf of a customer over FedWire, the payment is final. The transfer is effected via the reserve accounts of the sending and receiving banks on the books of the Federal Reserve. Therefore payments executed over FedWire entail no extension of credit between banks. It is the Federal Reserve that is at risk if the sending bank fails. But there is no risk of a collapse of the FedWire payments system and therefore no risk of a systemic collapse.

Under CHIPS (Clearing House Interbank Payments System), which moves approximately 27% of the nation's payments, such a collapse is theoretically possible, but extremely unlikely to occur in practice. Even if a large participant were to fail (itself an unlikely event), other banks need not become insolvent. A receiving bank would become insolvent, only if the probable loss from its claim on the failed bank exceeded its capital.

This is unlikely to be the case. The receiving bank does not lose the entire amount of its claim on the failed bank, but only a relatively small fraction. For example, at a 20% loss ratio, the receiving bank's claim on the failed bank would have to be five times its own capital before the receiving bank's capital would be exhausted.

Thus, preserving the stability of the payments system in the case of a big bank's failure amounts first, to limiting the possible exposure of the receiving bank to the sending bank that fails and second, to assuring that in the case of a failure, the receiving bank's claim on the failed bank is made as liquid as possible.

Proposals have been made that would accomplish both objectives. CHIPS has introduced a system of bilateral credit limits that would limit the exposure of any one participant in CHIPS to any other participant. These bilateral caps could be reinforced by limits on the total overdraft that any one institution could maintain aggregated over all electronic payments systems, including FedWire, a process CHIPS is currently testing.

As mentioned above, the second prerequisite for preserving the stability of the payments system in the event a big bank fails is that other banks are kept liquid. There are two approaches to consider. First, if it needed to, the receiving bank could borrow at the discount window. The Federal Reserve would, by acting as a lender of last resort, keep receiving banks liquid and keep the payments system functioning. What the Federal Reserve should not do is to become a lender of first or second resort. It should commit itself to let insolvent banks fail, and it should commit itself to lend freely to solvent but perhaps illiquid banks. Such loans to solvent but illiquid banks should be at a penalty rate to avoid abuse of the lender of last resort facility.

The second approach is to make other banks' claims on the failed bank liquid. The modified pay-off approach itself would largely accomplish this. Upon the failure of a bank the FDIC would pay off insured deposits immediately and allow uninsured depositors to withdraw some portion of their claim on the failed bank in cash. The remaining portion of their claim on the bank could be paid in negotiable receiver's certificates, which the uninsured depositor could sell at a discount if he wished. Thus, the modified payoff approach would impose losses on the receiving bank but it would enable the receiving bank to obtain immediately practically the entire net present value of its claim on a failed bank. Thus, the receiving bank would remain liquid.

In sum, the potential danger to the payments system arising from the failure of a big bank is manageable. Credit limits under development at CHIPS and the Federal Reserve limit the exposure of any one bank to the failure of another. The modified payoff approach would further reduce banks' effective potential exposure, for it would make claims on failed banks liquid. Together credit limits and the modified payoff approach practically eliminate the prospect of one bank's failure setting off a chain reaction of bank failures that would bring down the payments system.

7/30/85

With the payments system protected, the Federal Reserve and FDIC could allow any bank that became insolvent to fail, no matter how large that bank was. Moreover, actually letting a big insolvent bank fail and actually imposing losses on uninsured depositors would increase depositor discipline and reduce the probability of future bank failures. It would turn the vicious circle described at the outset of this section into a virtuous one.

Moreover, the modified payoff approach would also solve the problem of equity among banks that appeared after Continental Illinois. Deposits at big banks would be treated like deposits at small banks. The first $100,000 per depositor would be guaranteed; the rest would not, regardless of the size of the bank in which the funds were deposited. This is fair to all — big banks, small banks and depositors themselves, who would know with certainty what is and what is not guaranteed.

Subordinated debt. A second means to enhance market discipline on banks is to require banks to issue subordinated debt. The FDIC has proposed that banks be permitted to use subordinated debt to finance an increase in their capital from 6% to 9% of total assets. The issue of subordinated debt would create a class of investor who stands to lose when a bank fails and assets are found to be seriously depreciated. With funds at risk, the investor of suboridnated debt will have every incentive to assess that debt in terms of his own preference for risk and reward. Consequently, banks with riskier portfolios may find it difficult to fund or will have to pay more for funds than banks with low-leverage, low-risk portfolios. Thus, subordinated debt would enhance the discipline that uninsured depositors already provide.

7/30/85

Specifically, subordinated debtholders could be expected to closely monitor the net worth of the banks that issue the debt. They would probably demand covenants that would enable them to restrict a bank's activities or to take control of a bank whose net worth was approaching zero. Activation of such covenants would signal the FDIC and bank regulators that the bank should possibly be closed. This would limit the loss to the FDIC.

As currently proposed, the option to use subordinated debt to meet increased capital requirements refers to the bank alone. That is entirely appropriate. Some deposits are insured, and it is entirely appropriate that these insured deposits be backed by assets and capital sufficient to minimize the risk of loss to the FDIC. Subordinated debt at the bank level does just that. In the event of bank failure subordinated debt ranks junior to deposits. Use of subordinated debt thus frees up more of the banks assets for use in satisfying the claims of uninsured depositors and the FDIC.

One of the greatest strengths of the FDIC's current proposal is that it implicitly distinguishes between banks and bank holding companies. Bank holding companies are merely investors in banks; they should be free to determine their own capital structure in the marketplace. The market effectively monitors and disciplines bank holding companies now. This should be permitted to continue. Protection for deposits, especially insured deposits, should be concentrated at the bank level, where it has the most direct impact.

However, one should not expect too much from subordinated debt. It is a useful supplement to the coinsurance provided by uninsured deposits. Indeed, we would expect that adoption of the modified pay-off would induce banks to issue subordinated debt voluntarily, as a means of reducing the risk of uninsured deposits to large depositors.

But subordinated debt should not be a substitute for the modified pay-off. That would place the entire burden of monitoring a bank on the subordinated debtholder. Refusal to adopt the modified pay-off would imply that all deposits are insured, and thus sacrifice the considerable depositor discipline that currently exists. In the case of the largest banks it would mean giving up discipline from holders of liabilities amounting to at least two thirds of the bank's assets and placing complete reliance on discipline from holders of liabilities amounting to at most 3% of assets.

Furthermore, without the modified pay-off the marketability of subordinated debt becomes much more problematic. If regulators remain reluctant to close an insolvent bank, subordinated debtholders will be exposed to extreme risk. Subordinated debt may provide a cushion to the FDIC in the case of bank failure, but subordinated debtholders will only provide that cushion, if they can limit their loss when a bank's net worth (shareholders' equity) is exhausted. The modified pay-off provides that "stop-loss insurance" to the investor, for it assures that no bank will be too big to fail, and that insolvent banks will be promptly closed.

The Condition of the FDIC. What would be the condition of the FDIC under the market approach (modified pay-off supplemented by the use of subordinated debt) that we have outlined? Would the premiums charged banks reflect the risk to the fund? Would the fund be sufficient to offset possible losses? In sum, would the FDIC itself be safe and sound?

7/30/85

Table 3. Distribtuion of Insured Deposits, June 30, 1984

Total Domestic Deposits ($ millions)	Number of Banks[a]	Insured Deposits[a] ($ billions)	Share of Total Insured Deposits[a]
5,000+	26	200.5	17.2
100–5,000	1,990	595.5	51.0
Less than 100	12,437	371.3	31.8
Total	14,453	1,167.3	100.0

a. Figures refer to insured commercial banks.

Source: DRI, Sheshunoff Data.

Several factors would contribute to the strength of the FDIC. First, limited deposit insurance, backed up by a modified pay-off and supplemented by subordinated debt, would minimize potential losses to the FDIC. The risk to the FDIC would basically be the risk that the chartering agencies will be unable or unwilling to close banks in a timely fashion. And, under the program of modified pay-offs, with the payments system safeguarded as outlined above, chartering agencies should be more willing to close banks in a timely fashion. Indeed, the increased depositor discipline implied by the modified pay-off approach is likely to force regulators to close insolvent banks more promptly.

Moreover, under the modified pay-off approach the FDIC would not bear the entire loss of a bank failure. The FDIC would take full advantage of the coinsurance provided by uninsured depositors. The FDIC would limit its guarantee to deposits of $100,000; large depositors and depositors at foreign branches would participate on a pro rata basis in the recovery of the assets. This too would minimize the potential loss to the FDIC. The use of subordinated debt would provide further protection to the FDIC.

Secondly, under the modified pay-out approach the FDIC's risk would be well diversified. Over 80% of the insured deposits would be spread among the 14,500 banks with less than $5 billion in domestic deposits (Table 3). The 26 largest banks would account for only 17% of total insured deposits, and only one bank (Bank of America) would account for more than 2% of total insured deposits (Table 4).

Moreover, none of the largest banks would represent a threat to the insurance fund, if it were to fail. Only two commercial banks have total insured deposits greater than the size of the insurance fund, and

Table 4. Insurance Status of Deposits at 15 Largest Banks, June 30, 1984

	Total Deposits ($ billions)	Percent Uninsured	FDIC – Insured Deposits ($ billions)	Share of Total Insured Deposits in percent
1. Bank of America	90.4	57	39.0*	3.1
2. Citibank, N.A.[b]	79.9	80	15.8	1.4
3. Chase Manhattan	64.7	70	19.7*	1.6
4. Manufacturers Hanover	46.0	77	10.7	0.8
5. Morgan	40.0	98	0.8	0.1
6. Chemical	36.1	76	8.7	0.7
7. Security Pacific	29.2	53	13.8	1.1
8. First Chicago	28.0	82	4.9	0.4
9. Bankers Trust	27.9	92	3.1	0.2
10. Wells Fargo	19.4	27	14.1	1.1
11. Crocker	18.2	56	7.9	0.6
12. Continental Illinois	17.5	83	3.0	0.2
13. Marine Midland	17.3	56	7.7	0.6
14. First Interstate	15.6	56	6.9	0.5
15. Mellon	13.6	62	5.2	0.4
Total 15 largest banks	543.8	70	161.3	12.8

Source: DRI, Sheshunoff Data, FDIC Annual Report 1983.

Asterisk denotes that insured deposits are greater than the size of the insurance fund.

a. Total insured deposits at all banks calculated as of December 31, 1983. Therefore the share of each bank as a percent of total insured deposits is an overestimate.

b. Other bank subsidiaries of Citicorp had approximated $1.6 billion in FDIC insured deposits. In addition, thrift subsidiaries, which are insured by the FSLIC, had $7.4 billion in total deposits.

in both cases the FDIC would be protected from grave losses by coinsurance from uninsured depositors (Table 4).

Thirdly, the FDIC could continue to rely, as it does now, on discipline by shareholders and management itself in order to prevent bank failure. Finally, the FDIC has what amounts to the ultimate reinsurance contract. It is backed by the full faith and credit of the United States, a guarantee of the highest possible credit standing.

In sum, the modified pay-off approach, coupled with safeguards for the payments system and supplemented by the use of subordinated debt, offers a way to enhance market discipline on banks and to strengthen the condition of the FDIC. The modified pay-off approach would prevent excessive risk-taking by banks, reduce the probability of bank failure, and lower the claims on the fund that could arise in case a bank did fail. The use of subordinated debt would enhance the market discipline provided by the modified pay-off. Thus, a relatively low, flat-rate premium, such as the rate currently charged on domestic deposits, would compensate the FDIC for the risk that it assumed and would produce adequate revenues to build an insurance fund sufficient to meet possible future claims.

7/30/85

2. Relying on Regulation

An alternative approach to the market-oriented approach outlined above is to insure all deposits (and thus abandon depositor discipline) and to regulate banks more stringently. The rationale for this approach is outlined in Recommendations for Change in the Federal Deposit Insurance System put out early in 1985 by the Working Group of the Cabinet Council on Economic Affairs, chaired by Thomas J. Healey, former Assistant Secretary of the Treasury for Domestic Finance (The Healey Report).[17]

The Healey Report is convenient to examine because it is a good summary of official thinking about the state of the deposit insurance system and about the direction deposit insurance reform should take. The analysis of the Healey report runs as follows: the FDIC has guaranteed all deposits ex post in the past. That means that there is de facto 100% deposit insurance. Insurance should continue at 100% in the future. The resources of the FDIC are inadequate to bear such a burden. The deposit insurance system should therefore be strengthened in order to avoid a 'crisis'. To provide that strength additional regulations should be placed on banks, including the imposition of risk-related deposit insurance premiums, an increase in the insurance fund (to be financed through the assessment of deposits in foreign branches of U.S. banks), restrictions on brokered deposits, and a merger of the insurance funds.

The argument of the Healey Report is flawed from start to finish. First, the deposit insurance system is working well. As demonstrated above, the market does not believe that there is de facto 100% deposit insurance. Comptroller Conover may have said that some banks are too big to fail, but his statement lacks the force of law and is hardly likely to be binding on his successor. More importantly, neither Comptroller Conover nor any other official has said anything about guaranteeing the liquidity of deposits — and this is a prime consideration for large institutional investors. It does an investor little good to know that he will ultimately receive his funds in full, if he cannot access those funds as needed to meet his own obligations. Thus, large depositors continue to exert market discipline over large banks.

Secondly, there is no reason to provide 100% coverage of all deposits. Complete insurance coverage would eliminate the considerable depositor discipline that currently exists, even after the failure of Continental Illinois. Moreover, providing 100% deposit insurance would significantly raise the risk to the insurance fund without providing additional protection to the savings of the average American, whose deposits are already fully insured.

Third, the proposed reforms are neither necessary nor sound. Taken together, they would reduce the efficiency of the banking system, politicize the credit process and possibly lead to credit controls. Along with the extension of insurance coverage to all deposits, the proposed reforms would be a long step toward the nationalization of the banking function, for they would inevitably require the insurance agencies to become involved in rating and pricing each of the risks that banks assume.

Finally, the major proposals in the Healey Report are flawed. Each would distort the banking system without necessarily improving the soundness of banks or the condition of the FDIC. Moreover, each would impose significant costs on bank customers and on society at large. It is far more efficient to let bankers assess the risks that banks will assume and to let large depositors assess the risk of banks.

Risk-related premiums. Risk related premiums have a strong theoretical appeal. In a competitive marketplace, insurance should be priced according to the risk to the insurer. Some say deposit insurance should be no exception and propose the imposition of risk-related, regulator determined deposit insurance premiums. Alternatively, some have proposed an equivalent measure, the introduction of risk-related capital requirements. Some have even envisaged introducing both risk-related insurance premiums and risk-related capital requirements.[18]

However, current proposals for risk-related deposit insurance do not meet the standard of competitively determined, risk-related insurance rates. Specifically, risk-related, regulator-imposed premiums are not priced according to the risk to the insurer. Current proposals do not recognize a major risk to the deposit insurance fund — the reluctance of bank supervisors to close an insolvent bank. If insolvent banks are promptly closed, the FDIC experiences only minimal losses, and a minimal, flat-rate premium, such as that currently levied on domestic deposits, fully reflects the risk to the FDIC.[19]

Second, risk-related, regulator-imposed deposit insurance premiums are not set in a competitive marketplace. All banks that are members of the Federal Reserve System must buy deposit insurance from the FDIC; they can not switch insurers, if they believe that the FDIC is charging excessively high premiums. Consequently, risk-related, regulator-imposed premiums are inefficient. They purport to mimic the market, but cannot do so effectively, for they substitute the judgment of one (the FDIC) for the judgments of the many participants in the market. Regulators will perform differently from the market, and there is no reason to believe they will perform better. Any evaluation of a bank's risk must be based on expectations regarding future events. Regulators are not necessarily superior forecasters.

If the FDIC really can devise a method of assessing the risk that a bank will fail, then there is no reason to restrict the use of such a method to the FDIC. The FDIC need only publish its method and identify the relevant information needed. Uninsured depositors can evaluate the FDIC method, obtain the information and employ this method to assess the risk that the bank will fail. They can then discipline the bank directly and far more effectively than the regulator.

In fact, risk related premiums are likely to make bad situations worse. Ex ante judgments of how risky a bank's portfolio will turn out to be are difficult to make. Invariably, premium rates will be raised only after a bank has become troubled. This can only exacerbate the situation. Adding premiums after the fact would only deprive a bank of vital working capital. Carried to extremes, large premium differentials may have the perverse effect of encouraging management to "bet the bank."

Even if these problems could be overcome, there would still be other drawbacks to regulator-imposed risk-related deposit insurance premiums. The most serious is that risk-related deposit insurance premiums could be used to allocate credit. Invevitably, those who classify banks into risk categories must make some judgment about the risk of various bank assets and assign some weight to each type of risk that a bank assumes. Over time considerable political pressure might develop lest risk classifiers assign a high weight to a particular category of loans (e.g. farm loans, home mortgages, foreign loans) that would tend to make banks reluctant to extend additional credit to these sectors. Thus, risk-related deposit insurance premiums would lead to the politicization of the credit process.

Another objection to risk-related, regulator-imposed premiums is that they would eliminate coinsurance, a risk-limiting feature common to competitively priced insurance. Current proposals for risk-related, regulator-imposed deposit insurance premiums implicitly assume that all deposits would be insured. This significantly raises the risk to the insurer, for it eliminates the coinsurance provided by uninsured depositors.

Even if some deposits remained uninsured, the imposition of risk-related, regulator imposed deposit insurance premiums would reduce depositor discipline. If the FDIC assesses and rates the riskiness of banks, there will be less incentive for uninsured depositors to do so. Assuming that the premiums assigned to different institutions will become public knowledge, errors or biases in assessing bank risk will cause the market to misprice the funds a bank buys or make it difficult to fund at all. The cost of this regulatory-induced market error will be borne by the banks and ultimately by society.

Increase size of insurance fund. A second proposal to strengthen the condition of the FDIC calls for an increase in the size of the insurance fund available to offset future losses that the FDIC may incur. Although the Healey Report concedes that determining the size of an "adequate" insurance fund is difficult, it asserts that the "fund should be sufficiently large to handle ongoing operations and to deal with the potential failure of at least one or two of the larger insured institutions without approaching fund insolvency." To finance the proposed increase in the insurance fund, the Healey Report recommends that deposits in foreign branches of U.S. banks be assessed.

The case for increasing the insurance fund rests on several false assumptions. The first is that the size of the insurance fund is the key to the maintenance of the public's confidence in the deposit insurance system. This is surely not the case. To the public, federal deposit insurance implies that their funds are protected by the federal government up to $100,000. It would be unthinkable to allow the FDIC to refuse to protect deposits below $100,000 on the grounds that the fund was exhausted. If this were to occur, a banking panic of unequalled severity would follow. Thus, the fund itself is irrelevant, and the ultimate guarantor is the U.S. Treasury, whose resources are inexhaustible. Consequently, the Healey Report errs in linking an expanded insurance fund with increased "confidence in the system."

The second assumption underlying the case for a larger insurance fund is that all deposits are insured. This is not the case de jure; it is not the case de facto, and it need not be the case in the future. Adoption of the modified pay-off approach would limit potential drains on the insurance fund. Thus, the risk to the FDIC is lower and the condition of the FDIC is stronger than assumed in the Healey Report. Uninsured depositors should and can bear part of the risk of bank failures. The fund is adequate relative to the FDIC's main purpose — the protection of the small depositor.

The third implicit assumption behind the proposal to increase the size of the insurance fund is that bank supervisors will continue to resist closing an insolvent bank. This is the source of considerable risk and loss to the FDIC. Rather than increase the insurance fund, it would be preferable for bank supervisors to close banks that are insolvent in a timely fashion. This will prevent large losses to the FDIC.

The final assumption underlying the case for a larger insurance fund as well as for assessing foreign deposits is that risk to the FDIC has increased due to the number and activities of large banks with deposits in excess of the insurance fund. The Healey Report states that 13 FDIC-insured institutions have deposits exceeding the size of the insurance fund as one reason why large banks pose greater risks to the insurance system. However, there have always been banks with deposits exceeding the size of the insurance fund. In 1970, for example, 14 banks fell into this category. In 1974, 18 did, in 1978, 15 did and in 1982, 14 did. There is nothing new in this and no reason on that account to increase the size of the fund.

Moreover, large banks tend to rely heavily on uninsured deposits for the bulk of their funds, and for this reason they present less of a risk to the FDIC than the Healey Report asserts. As of June 30, 1984 only two banks had insured deposits in excess of the size of the FDIC's insurance fund, and in each case the FDIC was well protected by coinsurance from uninsured depositors (Table 4).

According to the Healey Report a second reason that large banks represent a greater risk to the FDIC is that foreign loans are concentrated at large banks. The Healey Report asserts that foreign loans are inherently riskier than domestic loans and that large banks are hence more prone to failure than smaller banks that concentrate on domestic lending. But this ignores the history of bank failure in the United States. Aside from fraud, the major cause of bank failure in the

United States has been a lack of portfolio diversification, particularly in unit banking states in agricultural areas. Historically, foreign loans have proved to be far less risky than energy or farm loans, and they have enabled banks to reduce risk through geographic diversification. In fact, no U.S. bank has ever failed because of its foreign loan portfolio.

The assessment of foreign deposits. Finally, the case for increasing the size of the insurance fund ignores the adverse effects of the means chosen to finance that increase. Assessing deposits in foreign branches of U.S. banks will raise costs of the banks themselves and ultimately of the customers which banks serve.

Foreign markets, especially interbank deposit markets, are highly competitive. Spreads are very thin. Consequently, U.S. banks operating in these markets would find it very difficult to adjust their rates to reflect the added costs of FDIC insurance. They could not pay depositors less. Just as in the United States, FDIC insurance matters little in foreign interbank and commercial markets. Large depositors are far more concerned with the liquidity of the underlying instrument and the quality of the bank than the presence or absence of deposit insurance.

Nor could U.S. banks charge more to borrowers abroad. Borrowers could easily turn for funds to foreign banks which would be exempt from FDIC assessments. This would further increase the competitive advantages of foreign banks over U.S. banks that higher leverage, lower reserve requirements, larger lending limits and broader activity powers already give to foreign banks. The increase in competitive advantage would be particularly great for foreign banks with U.S. offices, since they would remain exempt from assessment on their non-U.S. deposits.[20]

Thus, if foreign deposits were assessed, U.S. banks would bear the cost directly. This would force these banks out of major wholesale markets abroad with adverse effects on the banks and on the U.S. role in the international economy. Consider what would happen to a U.S. bank trying to compete in the interbank market which accounts for a significant portion of the business conducted in the foreign branches of U.S. banks. Net interest income on interbank placements has traditionally been narrow, commonly no more than 1/16 of 1%. By virtually eliminating the profit associated with this activity, the imposition of assessment costs may well exclude the foreign branches of U.S. banks from this market. Similarly, the increased assessment costs will significantly reduce net interest income on foreign loans, typically in the range of 3/8 of 1% to 5/8 of 1%, thus reducing the foreign income of U.S. banks (as well as U.S. tax revenues). At a time when U.S. bank regulators and Congress are urging U.S. banks to strengthen their capital base, it seems contradictory to contemplate legislation which would reduce earnings and jeopardize their competitiveness.

Forcing U.S. banks out of the international interbank market would adversely affect U.S. banks over and above the loss of income and would also impair the liquidity and efficiency of that market. From the point of view of an individual bank, one of the major effects of the development of a broad and deep international interbank market has been to enlarge considerably its scope for conducting international operations. By establishing interbank credit lines and facilities, a bank has the possibility of stengthening its network of correspondents and, more generally, its business relations with other institutions operating internationally. This is a prerequisite for access to the syndicated credit market. In addition to being a source of income, interbank transactions provide an indispensable support to other banking activities, foreign exchange in particular.

For the international banking system as a whole, the interbank market performs a major allocational function insofar as it permits an efficient matching of final depositors' and borrowers' preferences. It is a truly international money market, linking the various compartments of the international financial system to the corresponding domestic markets, thereby playing a vital role as a major channel for the international transmission of interest-rate changes.

The imposition of FDIC assessments on the deposits in the foreign branches would, for all practical purposes, remove U.S. banks as major players in markets where they continue to be challenged by foreign competitors. Shortly after World War II, U.S banks held 50% of the assets of the world's 100 largest banks. By the end of 1983 the percentage had declined to 14%.[21] The downward trend continued even after the creation of IBFs. Increased operating costs due to assessment charges will further stifle U.S. banks' efforts in responding to foreign bank competition.

Making it more difficult for U.S. banks to compete abroad also has adverse consequences for the foreign accounts of the United States. As has been recognized by the Administration, services are now the most important segment of the U.S. economy, and are the key to the future competitiveness of the U.S. in international markets. Services, including government, account for two-thirds of U.S. gross national product and 70 percent of U.S. employment.[22] The United States is the largest exporter of services ($34.9 billion in 1980), and it is believed the amount of U.S. service sector exports is much greater than those reported. In this connection, a study done for the Departments of State and Commerce and the Office of U.S. Trade Representative ("USTR") estimated that foreign revenues from the international business operations of the U.S. banking industry in 1980 were $9.1 billion (on a net basis), making banking the second largest U.S. service sector internationally in terms of revenue.[23] In light of the uniform and consistent Administration efforts to reduce barriers to U.S. banks and other service industries abroad, it would indeed be paradoxical to impose a cost barrier — the imposition of FDIC assessments on foreign branch deposits — which would do so much to damage the capability to compete overseas. The U.S. trade accounts as well as the service accounts may also suffer, if increased costs would make it more difficult for U.S. banks to accommodate the export and other international financing needs of their U.S. customers. This result too, would be contrary to Administration efforts to increase U.S. exports and create a more open environment abroad for foreign direct investment.

A final reason not to assess foreign deposits is that this may create an impression that some or all of such deposits are de facto insured, although they are not insured de jure. Thus, assessing foreign deposits would potentially expose the FDIC to a new type of risk — political or sovereign risk. In the case of nationalization of a U.S. bank's foreign branches depositors might look to the FDIC for reimbursement, even if the bank itself did not fail. Clearly, the extension of insurance coverage to deposits at a bank's foreign branches would significantly alter and increase the risk faced by the FDIC. The FDIC is best left to its original mandate -- the insurance of small domestic deposits against bank failure.

The original decision to exempt deposits in foreign branches from FDIC assessment and coverage was not made inadvertently. The legislative history of the Federal Deposit Insurance Act ("FDI Act") clearly establishes that Congress deliberately excluded deposits at foreign branches from the deposit insurance assessment base because it concluded that the additional costs associated with such assessments would put U.S. banks at a serious competitive disadvantage in overseas markets.[24] For similar international competitive reasons Congress has excluded deposits at foreign branches of U.S. banks from Federal Reserve reserve requirements and federal interest rate controls.[25] This policy was recently reaffirmed by Congress in the Monetary Control Act of 1980.[26]

Exemption of foreign branch deposits from FDIC assessments is thus part of a longstanding, consistent public policy that has been designed by successive administrations and Congresses to maintain the competitiveness of U.S. banks in foreign markets. There is no justification for changing this policy now.

Brokered deposits. Restrictions on insurance coverage for brokered deposits have been proposed by the FDIC and the FHLBB to reduce possible drains on the insurance funds. Setting a limit of $100,000 per broker on deposits placed in anyone institution, as the insurance agencies have tried to do, would kill a highly efficient, competitive market for funding financial institutions. This competition insures that funds that are in excess supply are redeployed to where they are in demand, thereby maximizing the returns that consumers can receive. And for a bank that purchases brokered funds, the all-in cost compares favorably with the costs that would be incurred from an individual effort to raise such funds. Brokered deposits broaden the market for funds and therefore can be expected to provide banks a wider variety of instruments to manage exposure to rate risk. For example, deposit brokers can easily supply zero coupon CDs enabling and encouraging banks to offer long-term, fixed rate loans to consumers.[27]

The insurance agencies justify restricting insurance on brokered deposits and effectively putting an end to this efficient and competitive market on the ground that brokered deposits make it easier for management to pursue extremely risky policies. There have indeed been individual and dramatic instances where troubled institutions acquire risky assets financed with brokered deposits supplied at above-market rates. But the way to restrict such abuses and the disadvantages they create for competitors is via the supervisory powers of the chartering and examining authorities. Specifically, if insolvent banks and thrifts are closed promptly, shareholders and management will not be encourgaed to bet the bank no matter how these bets are financed. In short, the choice of funding vehicle is irrelevant insofar as the possible risk to the insurance funds.

Moreover, recent studies show that brokered deposits have not played an important role in the funding of most of the banks and thrifts that have failed or required assistance. In a small number of cases, failed banks and thrifts did rely on brokered deposits for a substantial portion of total funding. These firms also purchased other forms of liabilities in large denominations, suggesting that even without brokered deposits, these institutions could have easily funded risky assets from alternative sources. Brokered deposits have also played a relatively minor role in funding the growth of problem institutions that have nevertheless continued to grow very rapidly. This too demonstrates that brokered deposits are not to blame for the increased risks that some depository institutions accept.[28]

Merging the insurance funds. The propsal to merge the federal insurance funds has two purposes. First, the merger would help to streamline the regulatory apparatus that governs depository institutions. Second, the merger would strengthen the insurance funds by pooling their resources. Now, however, is not an opportune time to implement such a proposal. But in the future, merger could well happen as a natural consequence of the continued erosion of the line that separates thrifts and commercial banks.

Pooling the resources of the insurance agencies at this time on the theory that this will strengthen FSLIC and help solve the thrift crisis is a mistake. Moreover, merger could impede the search for a solution to the thrift crisis if it creates the impression that problems in the banking industry parallel those in the thrift industry. The thrift crisis is a direct result of the regulation that restricted thrifts to portfolios comprised of long-term mortgages which traditionally carried fixed rates. Funding primarily with short-term funds, thrifts characteristically took massive interest rate risk and consequently were vulnerable as interest rates increased rapidly and became more volatile during the latter half of the 1970s. Permitting insolvent thrifts to continue in operation compounded the problem. It induced some thrifts to take even more risk, produced further losses and added to the potential drain on FSLIC. Merging the insurance funds does not address this problem. It merely passes the burden to a sound commercial banking system. The thrift crisis must be solved directly.

III. Conclusion

The deposit insurance system is not broke. The market still disciplines banks. However, the deposit insurance system can be improved, indeed must be improved, if it is to meet the challenges posed by brokered deposits, by regulators' reluctance to close insolvent banks and by the rescue of troubled large banks such as Continental Illinois.

To meet these challenges society can go in one of two directions. The current system of bank regulation and deposit insurance can be modified in one of two ways. To discipline banks society can either increase its reliance on regulation or increase its reliance on the market. It is not possible to do both at the same time. Strengthening regulation weakens the incentive of market participants to monitor and discipline banks independently.

Increasing regulation will not meet the challenges faced by the FDIC. Increased capital requirements and risk related premiums will not necessarily reduce the risk of bank failure and need not lead to a more stable banking system. But such regulations will impose significant costs on banks and their customers.

Relying more on the market will improve the deposit insurance system. If the FDIC adopts a modified pay-off approach to handling bank failures, large and small, the limit on deposit insurance coverage becomes effective and certain. This increases the probability that uninsured creditors will lose when a bank fails. Nothing concentrates the financial mind so powerfully as the possibility of loss. Remove the hint that the FDIC will bail out uninsured depositors and they will monitor and discipline banks even more effectively than they do now.

Supplement the modified pay-off with subordinated debt and market discipline will increase further. Return the FDIC to its original mandate of protecting the small and presumably unsophisticated depositor, and it will be in robust condition.

So long as the payments system can be safeguarded - and it can be, if banks limit the credit that they extend to each other - there is no justification for regulating banks to protect each and every bank from failing. Permitting the market to work more effectively will not endanger the stability of the banking system. Rather it will ensure that banks must compete with each other for the benefit of consumers. Letting the market work will also ensure that no bank is too big to fail. That result is fair to banks, fair to depositors and fair to the FDIC.

In sum, the deposit insurance system has stood up well to the strains placed upon it by the worst economic disruption since the Great Depression. No overhaul is needed. However, a tune-up may be in order. Citicorp believes that this should involve a return to first principles: keep deposit insurance solely a guarantee of small deposits, and let the market work.

7/30/85

Notes

1. Although the number of bank failures has risen significantly in recent years, the rate of bank failures is low relative to the rate of business failures and relative to the rate of bank failures that prevailed prior to the creation of the FDIC. Even in 1982 and 1983 the bank failure rate was less than one-third the general business failure rate:

Bank and Business Failure Rates, 1979-1984

	Number of bank failures[a]	Bank failure rate in percent[a]	Business failure rate in percent
1979	10	0.07	0.28
1980	10	0.07	0.42
1981	10	0.07	0.61
1982	42	0.29	0.88
1983	48	0.33	1.09
1984	79	0.54	n.a.

a. Failures and bank failure rate refer to FDIC insured banks.

Source: FDIC, Annual Report and U.S. Department of Commerce, Survey of Current Business.

7/30/85

Even the peak bank failure rate reached in 1984 of 0.54% is significantly below the bank failure rates for periods before the creation of the FDIC. For example. the bank failure rate for 1875 to 1929 was 1.02% and that for 1930-1933, the depth of the Depression, was 13.5%. Cf. George G. Kaufman, "Consequences of the Failure of One or More Banks on Other Banks, the Stability of Financial Markets and National Economic Activity," (mimeo, 1985).

2. "Survey of Consumer Finances, 1983," Federal Reserve Bulletin 70 (1984): 685.

3. The concentration of uninsured deposits at large banks reflects one result of deposit insurance, namely that it permitted small banks to compete with larger banks on an equal footing. Deposit insurance permits small banks to attract funds at moderate rates despite having relatively undiversified portfolios. From the perspective of a depositor at a small unit bank, deposit insurance is a substitute for the risk-reducing diversification that intrastate and interstate branch banking would bring about. Thus, the small unit banks which ardently supported the introduction of deposit insurance in 1933 were then and are now, in many cases, just as fervently opposed to intrastate and interstate branch banking, whether regional or nationwide. (See Carter H. Golembe, "The Deposit Insurance Legislation of 1933," Political Science Quarterly (1960): 181-200.

Like branching restrictions, activity restrictions also limit the ability of banks to diversify portfolios. Banks are therefore less able to defend themselves against adverse changes in the markets to which they are confined. Deposit insurance substitutes for the risk-reducing diversification of assets and activities that banks would otherwise undertake.

4. See Tim Carrington, "U.S. won't Let 11 Biggest Banks In Nation Fail," Wall Street Journal, September 20, 1984.

5. See John Helyar and Jeff Bailey, "A Smaller Continental Tries to Rebuild," Wall Street Journal, May 10, 1985.

6. John Helyar, "After the Fall: Banks Act to Minimize Risk in Their Dealings with Large Brethren," Wall Street Journal, October 15, 1984.

7. Helyar and Bailey, "A Smaller Continental Illinois".

8. John Morris, "Duff and Phelps is First Rating Firm to Evaluate Bank Deposit Certificates," American Banker, July 1, 1985; New York Times, July 3, 1985. Keefe, Bruyette & Woods and Cates Consulting also rate bank CDs.

9. L. Macdonald Wakeman, "The Real Functions of Bond Rating Agencies," The Modern Theory of Corporate Finance, Michael C. Jensen and Clifford W. Smith, Jr., eds. (New York: McGraw Hill, 1984), p. 395. Banks should willingly submit to the market discipline implied by a rating since they will be able to sell CDs at lower rates if CDs are rated.

7/30/85

10. Non-bank firms that issue debt impose self-regulation in the form of covenants that restrict the ability of management to take risks that would adversely affect the position of the bondholders. Typically, such covenants are developed by the managing underwriter, monitored and enforced by the trustees for the issue and by bond rating agencies. Thus, bondholders do not entirely rely on their own resources to discipline firms, and, if banks were unregulated, it is probable that similar market institutions would develop to discipline banks. Cf. Clifford W. Smith, Jr. and Jerold B. Warner, "On Financial Contracting: An Analysis of Bond Covenants," Journal of Financial Economics 7 (1979): 117-161.

11. Cf. Charles P. Kindleberger, Manias, Panics and Crashes: A History of Financial Crises (New York: Basic Books, 1978), pp. 161-163.

12. In addition to the lender of last resort facility, the guarantee of payments made over FedWire may also dilute depositor discipline. FedWire is an electronic funds transfer system operated by the Federal Reserve System. Payments made over FedWire are final, i.e. the Federal Reserve guarantees that the recipient receives good funds immediately. In contrast, payments transmitted over other electronic systems are not good funds until the end of the day, and payments made by check are not good funds until the check clears. In the interval before settlement is made, the payee runs the risk that either the payor's bank will fail or the payor will fail. Payments transmitted over FedWire are not subject to either risk. Thus, the Fed's guarantee of payments over FedWire enables the demand depositor who becomes concerned about the condition

of a bank to transfer his funds out of the bank quickly and safely. This may provide the depositor in a highly troubled bank some assurance. For a description of FedWire see "Federal Reserve Operations in Payments Mechanisms: A Summary," Federal Reserve Bulletin 62 (1976): 486-487. There are good arguments why the Federal Reserve should not guarantee payments made over FedWire.

13. Cf. William Hall, "First Chicago Rides Storm," Financial Times, July 5, 1985.

14. A bank can be said to fail when it ceases independent operations, i.e. when it closes or when the FDIC intervenes to provide assistance and/or replace management. In this sense Continental Illinois would be counted as a failed bank.

15. When the FDIC began experimenting with closing a failed bank in preference to finding merger partners for it, uninsured depositors received an average cash advance of over 40% of the uninsured balance in addition to the $100,000 covered by insurance. At a large bank (domestic deposits of over $5 billion) where the average large deposit was $452,000 in June 1984, the uninsured depositor would receive an immediate cash payment of $241,000, or over half of his total deposit.

In addition to this cash payment the uninsured depositor would receive receiver's certificates for the balance (60%) of his uninsured deposits. These could be sold immediately at a discount or the depositor could wait for disbursements from the FDIC as it liquidated or reorganized the bank. Assuming that the receiver's certificates could be sold at half their face value, the depositor at a large bank would realize another $106,000, bringing his total recovery to $347,000 or about 75% of his total deposit. In other words, total losses might amount to 25% of the depositor's original balance.

To ease the transition from the current system to a modified pay-off, cash advances might be set somewhat higher to start with and then scaled down to what the FDIC is currently proposing - an advance based solely on the present market value of the bank's assets. The end result would seem to be well worth the temporary risk to the Fund's assets.

16. Federal Advisory Council/Thrift Institutions Advisory Council, "Report of the FAC/TIAC Payments System Committee," mimeo, November 2, 1983, pp. 6, 8.

17. The Healey Report is convenient to cite because it contains many of the ideas for deposit insurance reform that have been discussed in recent years. The Garn St Germain Act of 1982 required that the FDIC, the FHLBB and the NCUA make proposals for curbing the risks that banks might take in the newly deregulated environment. The reports of the FDIC and the FHLBB in general recommended that newer and more sophisticated ammunition be added or substituted for the existing arsenal of controls and regulations. The FDIC's report also considered alternatives to increase the role of the market in disciplining banks. It has recently resurfaced these ideas asking for comments on a proposal to switch from the present purchase and assumption transaction to a modified pay-off in cases where a troubled bank is merged rather than liquidated and for comments on a proposal to increase capital

requirements where the increase may be financed with subordinated debt. Both of these proposals are discussed below.

The Continental episode and the foreign debt crisis heightened interest in reform, broadened the discussion, and sparked other sets of proposals. In addition to various governmental bodies, the academic community, which has long been concerned with deposit insurance reform, has contributed to the current debate. A recent example is Edward J. Kane's The Gathering Crisis In Federal Deposit Insurance (Boston: MIT Press, forthcoming).

18. Stephen A. Buser, Andrew H. Chen and Edward J. Kane, "Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital," Journal of Finance, 35 (1981): 51-60, stress that adding variable rate premiums onto the present regulatory structure is redundant, however such a system is implemented. The present regulatory system already combines a flat explicit insurance premium with what may be called risk-related implicit premiums linked by the regulators to the state of a bank's financial health. This produces an effect comparable to variable rate premiums. Consequently, adding variable rate premiums onto the present regulatory structure without lifting other restrictions (activity restrictions, capital requirements) constitutes regulatory overkill.

19. Cf. Paul M. Horvitz, "Why Risk Related Insurance Premiums Are No Answer," American Banker, May 26, 1983, p. 4.

20. U.S. banks that are subsidiaries of foreign bank holding companies would also be at a competitive advantage, since the deposits of the

foreign bank subsidiaries of the foreign bank holding company would be exempt from deposit insurance assessments.

21. American Banker, July 31, 1984.

22. "U.S. National Study on Trade in Services," U.S. Government Submission to the General Agreement on Tariffs and Trade (Washington, December 1983), pp. 22-23.

23. Economic Consulting Services, Washington, D. C.

24. See Hearings on H.R. 5337 before the House Committee on Banking and Currency, 74th Cong., 1st sess. 71-72 (1935).

25. See paragraphs 19(b)(6) and 19(j) of the Federal Reserve Act, 12 U.S.C., paragraphs 461(b)(6) and 371b.

26. See paragraph 103 of P.L. 96-221.

27. Sanford Rose, "In Praise of Brokered Deposits," American Banker, March 20, 1984, p. 1.

28. Study by Cates Consulting Analysts of New York, cited in Sanford Rose, "Refocusing on Brokered Deposits," American Banker, February 26, 1985 and U.S. House of Representatives, Committee on Government Operations, "Federal Regulation of Brokered Deposits," 98th Cong., 2nd sess., Report 98-1112, September 28, 1984.

7/30/85

Chairman **St Germain**. Now we will hear from Roger Lumpp, who is vice president of the CNA Insurance Co's. Mr. Lumpp please proceed.

STATEMENT OF ROGER E. LUMPP II, VICE PRESIDENT, CNA INSURANCE CO'S.

Mr. **Lumpp**. Thank you very much, and good morning. The first two-thirds of my prepared statement provides an overview of the practicality of the private insurance industry being an alternative to the mechanism in place today insuring deposits.

Practically speaking, it is not an alternative. The key reason is the fact that the amount of net surplus or the capital in place today in the U.S. property and casualty industry as a whole is in many ways under the same kinds of stress as is the net surplus of the FDIC and the FSLIC.

In hindsight, it would appear the rate of premium charged for risks covered appears to have been substantially too low in both the private and the Federal case. Property and casualty insurers have raised rates in 1985, but it is likely rates will escalate even further in the next period.

Rate increase is being discussed by the Federal deposit insurers as a needed action to improve their position also. Overall rate of return for each type of insurer has caused problems in recent years. Traditionally conservative in the rates of interest used to project investment income, property, and casualty management faced a new, totally uncharted environment over the past 10 years.

Those high rates of return brought attendant higher rates of the potential loss of the underlying principal. Some property and casualty companies will survive and some may not. The same rate of return quality of asset dynamic has been faced by banks and thrifts and the deposit funds themselves. Some will survive and some may not.

One important additional development working against private insurance surplus is the degree to which capital is being called upon to pay out 1985 style settlements for exposures insured with 1980, 1970, 1960, and, in some cases, even 1950 level premiums.

This double whammy combination of the inflationary years of the seventies with some civil justice trends of the mideighties is making it very, very difficult for the private insurers to reserve for current losses and to anticipate future losses in pricing their products.

This is a very major problem for the private property and casualty industry today.

One final parallel between the property and casualty industry and the Federal deposit funds is the concern of the regulators. Property and casualty regulators are concerned about insurer solvency and the overall confidence placed in a system which causes coverages which are very close to home and highly sensitive to become very expensive, and, in some cases, not available at all.

Federal regulators are concerned about bank and thrift solvency and confidence in a system that hits just as close if not even closer to home.

In both cases, not just our countrymen but, in fact, the whole world is watching. Again, practically speaking, for all the above reasons and as detailed quite a bit more in my prepared statement, the private insurance industry is not prepared to replace the deposit insurance mechanisms in place today.

The timing could probably not be worse for us to put the deposit insurance problems on top of the other problems faced by the private insurance industry today.

But enough of practicality. Let me offer some observations from a conceptual standpoint. Let's assume for a moment that the banking industry was in its best health, that the insurance industry was also in a better health, and that international wealth, an important source of reinsurance, was anxious to explore this new insurance frontier.

How would they view the prospect of insuring deposits in U.S. financial institutions?

Assuming the insurers were able to comfort themselves with the condition of the industry and the adequacy of the examination and regulation process, they would have to address themselves to the other, more traditional aspects of an insurer relationship.

This would include establishing underwriting guidelines, insurance limits, cancellation rights, deductibles and the rate to be charged for the underlying insurance.

Let me focus for a moment on the most important of these aspects:

If traditional private insurance is to be a viable conceptual alternative, there will need to be an ability to underwrite. By that, I mean insurers will need to be able to select entities to insure which meet acceptability standards. Such standards are determined by projections of future losses expected to arise out of specific exposures on risks insured today, insured at a rate charged to yield an acceptable profit over time.

If an insurer cannot underwrite, he cannot price. If he cannot price, sooner or later, any arbitrary price will prove to be too low.

For instance, even with all the resource of the Government applied to deposit insurance and financial institution viability over the years, recent developments seem to suggest that the insurance funds appear to be in need of substantial recapitalization.

The very same regulator set which dictated the operating behavior of the financial institution set and at the same time collects deposit insurance from these same financial institutions has been unable to underwrite deposit insurance to an acceptable, quote, "profit" over time.

Therefore, it is unlikely that private insurers would ever have available the full results of the examination process, much less be authorized to dictate operating behavior of the deposit takers.

Given this reality, frankly, it is not even conceptually feasible to think of the private insurance mechanism replacing the Federal deposit insurance mechanism we have in place today.

Therefore, from a practical standpoint and in addition from a conceptual standpoint, I don't think we can get there from here. I don't think we'll see a time, frankly, in this century, when the banking and the insurance industry are both in quite a bit better shape and when international reinsurers would be excited at the prospect of exploring this relatively new frontier of insurance.

Well, what should we do about it?

Where do we go from here?

It seems clear that the Ohio situation pointed out that without the full and unlimited backing of someone people trust, banks and thrifts are potentially faced with what's been referred to as runs.

Today, I do believe the people still very much do trust the Federal insurance concept. But their confidence, I think, has been weakened a bit by the events of the last 6 to 12 months.

I do believe the way that we can improve upon the situation is to do two things, however. First of all, I don't think we should fix something if in fact it is not broken.

By that, I mean I do feel that many aspects of the present system work very well indeed for the interests of the overwhelming majority of depositors. Sudden movement to a variable rate from today's fixed rate, dramatic changes in subrogation strategies by deposit insurers and other such actions to solve today's problems may cause even greater exposures tomorrow.

Second of all, several years ago, we were all struggling——

Chairman St Germain. Excuse me. You just used the phrase, "variable rate"?

Mr. Lumpp. Variable rate.

Chairman St Germain. Is that another word for risk-related premiums?

Mr. Lumpp. Yes. Yes, sir.

Chairman St Germain. Would you expand on that just a little bit for us?

Mr. Lumpp. I happen to be of the opinion, and I think I share it with my colleague from Citibank, that risk-related premium is not something that we should move to very quickly.

Chairman St Germain. Why?

Mr. Lumpp. I think it causes—that movement of and by itself can cause institutions to take other actions which may cause many runs on institutions at a time when that probably isn't in our best interests.

I think charging an institution a higher rate of deposit insurance is going to cause its management in being all the more aggressive in trying to find additional sources of revenue, and that may not be a good development for us to find in the——

Chairman St Germain. Do you also have a problem with who and how the risk is judged? By whom is it judged, and how it is judged?

Mr. Lumpp. I must admit I have not probably read all I should and done all the research that I should on this question.

Chairman St Germain. Well, I've read a lot, tried to read a lot, but there isn't anything to read on that question. I mean, they throw it out but they don't say how and who is going to do it.

Mr. Lumpp. I think that would bolster all the more my concern than I sense it probably does yours.

Several years ago, we were all faced with what I might call an analagous situation with respect to the Social Security System. We all remember a period of deteriorating confidence in it.

Some cited deficient actuarial projections. Others cited runaway inflation and its attendant impact on the cost of labor.

Others said it was never intended to be the sole source of retirement benefits in the first place.

Whatever the case, we all began addressing that. The way we began addressing that problem may provide a way to get there from here in our deposit dilemma. Most of us are now funding our own retirement because the Federal Government made it attractive for us to set aside our own money in individual retirement accounts, KEOGH accounts, et cetera.

Over the next 10 to 20 years, the aggregate amount of money individuals will be able to set aside to support themselves will grow to the point where their Social Security check will represent a smaller and smaller element of their overall retirement plan.

I believe the way we may get there from here as it pertains to deposit insurance is to establish a similar set of mechanisms and incentives for individual units so that they have the ability to influence their own individual destiny.

How do we do that?

Here's a few rough ideas. First, devise a plan whereby over a reasonable amount of time, say, 10 to 15 years, federally-insured institutions take actions to establish the independent ability to be guarantors of an increasing portion of their own deposits.

The plan would likely include some sort of phasedown of the level insured by the Government funds today.

Second, establish a rating agency to rate institutions on an appropriate scale with the higher rated institutions eligible for higher rates of liability growth, and the lower rated institutions under pressure to improve their rating or to be precluded from growth.

The A.M. Best organization rates insurers today in a fashion which might provide a basis for comparison and a starting point.

These ratings would probably be rated on such operating characteristics as capital adequacy, loan loss reserve development, examination findings, et cetera.

Fourth, phasein of self-insuring will likely require each institution to fund some type of contingency reserve to cover probably future events. Such a contingency reserve might exist within each individual institution or as a freestanding pool similar to the guarantee funds found in the insurance industry today.

Five, require regular increases in capital based on the nature of or the extent of banking operations.

Six, undertake a campaign to broaden depositor citizen understanding of uninsured deposits, so that when the insured level decreases, the market can make intelligent decisions.

Seven, explore private insurance as a mechanism to protect some or all of the exposures that some or all depositors might have concerning some of the conditions leading to their losing some or all of their principal or interest.

Eighth, and finally, consider a system where depositors purchase the insurance themselves, rather than having the financial institution acting as the intermediary between the depositor and the insurer.

I would close that by asserting that, in my opinion, there may well be a role for private insurance in the deposit insurance arena in years to come. I believe some of these are very rough ideas that I've presented, have potential, but, in fact, they need additional input from other parties who might be directly or indirectly affected.

In conclusion, my company, CNA, has recently adopted a phrase which it incorporates into our corporate logo. You may have read it in our advertisements or heard about it on our radio campaigns. The phrase is:

"For all the commitments you make."

I believe the bank and thrift industries are in a period of some turmoil and may be approaching one of those junctures in history where deterioration accelerates or we in fact can turn it around.

I think that's where commitment comes in. I sense there is substantial commitment and I think it's very much in everyone's interests that we commit ourselves to improving the confidence placed in these financial institutions by protecting our citizens' investments. That's the way they do in fact view their deposits.

Thank you.

[The prepared statement of Mr. Lumpp follows:]

STATEMENT BY ROGER E. LUMMP II, VICE PRESIDENT, CNA INSURANCE COMPANIES

THE CONCEPT OF THE PRIVATE SECTOR INSURING DEPOSITS IN FINANCIAL INSTITUTIONS IS NOT NEW. AS A MATTER OF FACT, WE CAN BE CONFIDENT THAT CONSIDERATION WAS GIVEN TO THIS ALTERNATIVE MORE THAN FIFTY YEARS AGO WHEN THE PRESENT SYSTEM WAS PUT IN PLACE.

AS WE ARE AWARE, MANY CHANGES HAVE OCCURRED IN THE FINANCIAL SERVICES INDUSTRY IN THE PAST FIFTY YEARS. HOWEVER, THE BASIC STRUCTURE OF THE DEPOSIT INSURANCE MECHANISM REMAINS THE SAME AS IT WAS WHEN INITIATED. THIS IS AT THE SAME TIME REMARKABLE TESTIMONY AS WELL AS CAUSE FOR A REEXAMINATION OF THE CONCEPT. RARELY DOES ANYTHING REMAIN UNCHANGED OVER THIS LONG A PERIOD UNLESS IT IS A PIECE OF WELL-KEPT FINE ART OR A WELL-PRESERVED ANTIQUE. THERE APPEARS TO BE A CONSENSUS THAT THE DEPOSIT INSURANCE CONCEPT WE HAVE INHERITED IS NOT FINE ART. IN FACT, MANY CONSIDER IT AN OVERUSED, OUT-OF-DATE ANTIQUE.

WHATEVER THE CASE, I HAVE BEEN ASKED TO COMMENT FROM THE PERSPECTIVE OF THE PRIVATE INSURANCE INDUSTRY. MY COMMENTS WILL PRIMARILY FOCUS ON THE QUESTION OF WHETHER PRIVATE INSURANCE IS A VIABLE ALTERNATIVE TO FEDERAL DEPOSIT INSURANCE. I'LL BEGIN ADDRESSING THIS ISSUE FROM A PRACTICAL PERSPECTIVE BY MAKING SOME OBSERVATIONS ABOUT THE BANKING AND THEN THE INSURANCE INDUSTRY. I WILL THEN PROVIDE MY PERSONAL OPINION FROM A CONCEPTUAL STANDPOINT. FINALLY, I WILL RECOMMEND AN ALTERNATIVE WHICH I BELIEVE IS THE PREFERRED DIRECTION.

PRACTICALLY SPEAKING, PRIVATE INSURERS ARE NOT CURRENTLY AN ALTERNATIVE TO THE FEDERAL INSURANCE DEPOSIT FUNDS. I REFER TO FUNDS BECAUSE ONE CANNOT ADDRESS THE FDIC WITHOUT ADDRESSING THE FSLIC AS WELL AS ALL OTHER DEPOSIT INSURANCE MECHANISMS THAT ARE FEDERALLY OR OTHERWISE FUNDED. PRACTICALLY SPEAKING, ANY VIABLE ALTERNATIVE MUST BE ONE THAT CONSIDERS THE BROAD SPECTRUM OF DEPOSIT INSURANCE NEEDS.

HOW DOES AN INSURER VIEW THE BANKING INDUSTRY TODAY? IF THERE IS A WORD THAT EXPRESSES MY OVERALL FEELING ABOUT THE CONDITION OF THIS INDUSTRY IT IS THE WORD TURMOIL. WEBSTER DEFINES TURMOIL AS AN UTTERLY CONFUSED OR EXTREMELY AGITATED STATE OR CONDITION. I SUGGEST THAT THE DEVELOPMENTS OF THE PAST FEW YEARS, LET ALONE THE PAST FEW MONTHS, SUPPORT THIS WORD CHOICE. PENN SQUARE, THE BUTCHER BANKS, CONTINENTAL ILLINOIS, FINANCIAL CORPORATION OF AMERICA, HOME STATE, OLD COURT, BANK OF AMERICA, CHASE, DRYSDALE, ESM, BEVEL BRESSLER, EPIC. THESE ARE NAMES OF PROMINENT FINANCIAL SERVICES INSTITUTIONS WHICH HAVE SHAKEN WORLD CONFIDENCE.

ESCALATING FIDELITY AND LIABILITY LOSSES ASSOCIATED WITH FINANCIAL INSTITUTION ACTIONS DURING THE EARLY 1980'S HAVE, IN THE MID-1980'S, MATURED TO THE POINT WHERE OBSERVERS ARE INCREASINGLY CONCERNED ABOUT THE QUALITY OF MANAGEMENT AND MANAGEMENT CONTROL. HARDLY A DAY PASSES WHEN HEADLINES IN THE FINANCIAL PRESS DO NOT REPORT ACTIONS TAKEN OR COMMENTS MADE BY FINANCIAL INSTITUTION REGULATORS. INCREASINGLY, SUCH ACTIONS AND THOUGHTS ARE REFERRED TO AS PROVOCATIVE (AS AN EXAMPLE, NON-BANKS), POLITICALLY MOTIVATED (THE OHIO SITUATION) OR LACKING PERSPECTIVE (ACTIONS UNDERTAKEN ON BEHALF OF A FEW LARGE BANKS BUT AFFECTING THOUSANDS OF SMALL COMMUNITY INSTITUTIONS).

ADDITIONALLY, THERE IS MOUNTING CONCERN THAT TODAY'S SOPHISTICATION AND COMPLEXITY HAVE GROWN FASTER THAN MANAGEMENT'S ABILITY TO KEEP THEM UNDER CONTROL. THE GOVERNMENT SECURITY REPO, REVERSE REPO DEVELOPMENTS TO DATE ARE AN EXAMPLE. THE FACT THAT PENN SQUARE AND CONTINENTAL DEVELOPMENTS HAVE SUCH A VAST RIPPLE EFFECT IS ANOTHER EXAMPLE. A RELATED ISSUE IS THE GROWING CONCERN ACROSS ALL INDUSTRIES THAT THE WORST COMPUTER HACKERS MAY STILL BE INVISIBLE. RECENT DISCLOSURES REGARDING LACK OF COMPLIANCE WITH REGULATIONS REGARDING LARGE DOLLAR TRANSACTIONS DO NOT SPEAK WELL. FURTHERMORE, THERE IS A SENSE THAT THE MONEY LAUNDERERS ARE ALWAYS ONE STEP AHEAD.

THE TRADITIONAL ORGANIZATIONAL STRUCTURE FOUND IN LARGE BANKS TYPICALLY FEATURES LAYERS OF MANAGEMENT AND EXECUTIVES WHO ARE COMPETENT IN A FAIRLY NARROW RANGE BUT WHO COLLECTIVELY CREATE A WIDE GULF BETWEEN STRATEGIC POLICYMAKERS AND FRONT-LINE EXECUTORS. THIS IS ANOTHER SOURCE OF CONCERN REGARDING CONTROL.

I COULD GO ON CITING OTHER CONSIDERATIONS BUT LET ME CLOSE OUT MY PROFILE OF THE FINANCIAL INSTITUTION INDUSTRY BY MENTIONING A SET OF RECENT DEVELOPMENTS THAT ARE PARTICULARY UNSETTLING AS VIEWED BY THE INSURANCE COMMUNITY. NO, I AM NOT GOING TO TALK ABOUT ACTIONS TAKEN BY SOME FINANCIAL INSTITUTIONS TO AGGRESSIVELY ENTER INSURANCE PRODUCT DISTRIBUTION AND INSURANCE UNDERWRITING. BUT WHAT I AM GOING TO SPECIFICALLY ADDRESS IS THE WAY CERTAIN INSTITUTIONS AND REGULATORS HAVE MISPERCEIVED THE INTENT OF SOME INSURANCE CONTRACTS. UNDER THOSE CONTRACTS, THEY HAVE ATTEMPTED TO OBTAIN RELIEF FROM LOSSES THAT THE POLICIES WERE NOT WRITTEN TO COVER.

LET ME PROVIDE SOME EXAMPLES OF WHAT I MEAN. AN OBVIOUS ONE IS THE EFFORTS BY CHASE MANHATTAN AND BANK OF AMERICA TO SUE FORMER OFFICERS AND TO RECOVER FROM THE DIRECTORS' AND OFFICERS' LIABILITY INSURER. ANOTHER EXAMPLE IS THE INCREASINGLY VIGOROUS INCLINATION OF REGULATORS TO SUGGEST THAT LIABILITY POLICIES ARE, IN EFFECT, EXCESS DEPOSIT INSURANCE.

ACTIONS AND ATTITUDES SUCH AS THESE ARE SETTING A TONE THAT HAS A SUBSTANTIAL EFFECT ON STRATEGIC PLANNING WITHIN THE INSURANCE INDUSTRY, PARTICULARY WITHIN INSURANCE PRODUCT DEVELOPMENT CIRCLES. ONE IMPACT COULD BE TO CAUSE DIRECTORS AND OFFICERS OF FINANCIAL INSTITUTIONS TO BE DEEMED UNINSURABLE.

LET ME STOP NOW TO TURN TO SOME OBSERVATIONS ABOUT THE STATE OF THE INSURANCE INDUSTRY. I'LL START BY COMMENTING ON THE OBVIOUS. THE INSURANCE INDUSTRY IS ALSO TRYING TO FIGURE OUT HOW TO EXIST IN A "DEREGULATED" ENVIRONMENT. WE DON'T KNOW WHAT A BANK, BROKERAGE FIRM, FINANCIAL INSTITUTION OR INSURER IS GOING TO LOOK LIKE IN THE YEAR 2000. CONSEQUENTLY, A FAIR AMOUNT OF INDUSTRY RESOURCE IS BEING SPENT, AND OFTEN MISSPENT, TRYING TO FIGURE OUT THE ANSWER TO THIS, THE COMMON RIDDLE AMONG FINANCIAL INSTITUTIONS.

THIS EVOLUTIONARY AND, YES, REVOLUTIONARY EXERCISE IS BEING UNDERTAKEN AT A TIME WHEN THE PROPERTY AND CASUALTY INSURANCE INDUSTRY HAS COME THROUGH THE LONGEST AND, BY MOST ACCOUNTS, THE DEEPEST PRICE-CUTTING WAR IN EIGHTY YEARS.

THE BANKING AND INSURANCE INDUSTRIES ARE VERY MUCH ALIKE. SIMPLY STATED, BOTH RECEIVE MONIES AND INVEST THEM KNOWING FULL WELL THAT AT THE END OF A PERIOD OF TIME THEY WILL HAVE TO PAY THEM OUT AGAIN. THE PAST TEN YEARS FEATURED A BROAD ARRAY OF INVESTMENT RISK ALTERNATIVES, WITH THE ATTENDANT ARRAY OF RATE OF RETURNS. THEY HAVE BEEN YEARS WHERE ENTICING INVESTMENT ALTERNATIVES WITH HISTORICALLY HIGH YIELDS HAVE OCCASIONALLY DISTRACTED PORTFOLIO MANAGERS FROM CLOSELY EVALUATING UNDERLYING EXPOSURE TO LOSS OF PRINCIPAL.

IN THIS CONTEXT, YOU MAY RECALL THAT IN MY INDUSTRY SOME INSURERS HAVE HAD TO BORROW MONEY TO FUND SHORT-TERM CASH NEEDS BECAUSE IF THEY WERE FACED WITH LIQUIDATING IN THEIR INVESTMENT PORTFOLIO, IT WOULD HAVE TRIGGERED SUBSTANTIAL REALIZED CAPITAL LOSSES. IN THE SAME VEIN, NOT TOO LONG AGO THE UNREALIZED CAPITAL LOSS EXPOSURE IN THE INSURANCE INDUSTRY'S BOND PORTFOLIO WAS OF SUCH A MAGNITUDE AS TO CAUSE LIFE-THREATENING EXPOSURE TO SEVERAL HOUSEHOLD NAME INSURERS, WERE THEY FORCED TO BEGIN LIQUIDATING. BY THE WAY, NOT ALL COMPANIES HAVE TAKEN ACTION TO REDUCE THIS EXPOSURE, AND IF INTEREST RATES SHOULD RISE THEY WOULD BE IN SIMILAR STRAITS ONCE AGAIN.

NOW THAT I HAVE ORIENTED YOU WITH THE LEFT SIDE OF MY INDUSTRY'S BALANCE SHEET, LET ME COMMENT ON THE RIGHT SIDE. I MENTIONED EARLIER THE UNPRECEDENTED PRICE-CUTTING UNDERTAKEN IN RECENT YEARS. THIS HAS OCCURRED AT A TIME WHEN THERE IS GROWING CONCERN ABOUT THE LOSS RESERVES THAT INSURANCE COMPANIES PUT UP TO COVER FUTURE SETTLEMENTS. THIS CONCERN IS PROMPTED BY OUR INCREASINGLY LITIGIOUS SOCIETY AND BY A STILL-DEVELOPING TREND TOWARD--IN MY OPINION--EXCESSIVE SETTLEMENTS AND UNHEARD OF PUNITIVE DAMAGE AWARDS FROM A

CIVIL JUSTICE SYSTEM THAT MANY SUGGEST IS IN NEED OF MAJOR REFORM. THE GROWTH OF UNNECESSARY LEGAL FEES AND LACK OF PREDICTABILITY OF LOSS COSTS MAKE LOSS RESERVING MORE DIFFICULT THAN EVER BEFORE.

SOME INSURANCE COMPANIES HAVE ATTEMPTED TO OFFSET OPERATING RESULTS IN CURRENT PERIODS BY FUTURE TAX BENEFITS, CAUSING THE S.E.C.--UNDERSTANDABLY--TO INTERVENE. OTHER INSURERS ARE IN AS PRECARIOUS A POSITION AS SOME BANKS AND THRIFTS WE COULD MENTION TODAY AND ARE BEING PROPPED UP BY REGULATORS WHO CANNOT AFFORD TO ALLOW THEM TO FALL FLAT. IN SUMMARY, WE HAVE AN INDUSTRY WHOSE ASSETS MAY IN SOME WAYS BE OVERSTATED AND WHOSE LIABILITIES MAY QUITE POSSIBLY BE UNDERSTATED.

THE TOTAL SURPLUS OF DOMESTIC PROPERTY AND CASUALTY INSURERS STANDS AT APPROXIMATELY $60 BILLION. AS AN INDUSTRY, THIS REPRESENTS APPROXIMATELY A ONE-TWELFTH REDUCTION FROM THE SURPLUS LEVEL OF APPROXIMATELY ONE YEAR AGO. AS YOU MAY EXPECT, SOME COMPANIES CONTRIBUTED TO THIS REDUCTION MORE THAN OTHERS. WHATEVER THE CASE, THE NET AMOUNT OF EXPOSURES SUPPORTED BY THIS SURPLUS DID NOT DECREASE BY ONE-TWELFTH DURING THE PERIOD.

AN IMPORTANT THING TO KEEP IN MIND WHEN CONSIDERING ALTERNATIVES TO THE PRESENT DEPOSIT INSURANCE CONCEPT IS THE FINANCIAL CAPABILITIES OF THE BACKUP SYSTEM WHEN THE INEVITABLE CRISIS ARISES. STATE INSURANCE GUARANTEE FUNDS NETWORK INSURER SURPLUS TO COME TO THE RESCUE WHEN AN INDIVIDUAL INSURER CLOSES DOWN. $60 BILLION OF SURPLUS IS ALL THAT IS SUPPORTING TODAY'S COMPLEX PROPERTY AND CASUALTY EXPOSURES. LONG AND HARD THOUGHT SHOULD BE GIVEN TO STRETCHING THAT SURPLUS FURTHER THAN IT IS ALREADY EXTENDED TODAY.

FOLLOWING THIS TOUR THROUGH MY INDUSTRY'S BALANCE SHEET, LET ME NOW SINGLE OUT SOME SPECIFIC PROBLEMS. THIS SUMMER AN UNPRECEDENTED TRIAL BEGAN IN A THEATRE IN SAN FRANCISCO TO DEAL WITH THE RESOLUTION OF PART OF THE ASBESTOSIS ISSUE WHICH HAS RAGED IN THE INDUSTRY IN RECENT YEARS. I BELIEVE WE ARE ALL FAMILIAR WITH ENVIRONMENTAL IMPAIRMENT. BOTH PROBLEMS FEATURE THE INDUSTRY'S NEED TO PAY IN 1980 OR LATER DOLLARS FOR DAMAGES INCURRED "EVER-TO-DATE". BOTH THE ASBESTOSIS AND ENVIRONMENTAL IMPAIRMENT PROBLEMS ARE EXAMPLES OF LIABILITY EXPOSURES, THE ORDER OF MAGNITUDE OF WHICH COULD NOT CONCEIVABLY HAVE BEEN ESTIMATED WHEN ACTUARIES WERE PRICING THE LIABILITY POLICIES FOR THESE INSUREDS ONE, TWO, THREE, FOUR OR MORE DECADES AGO.

LET ME ROUND OUT MY DESCRIPTION OF THE STATE OF THE INSURANCE INDUSTRY BY REFERENCING SOME OF TODAY'S OPERATING ISSUES. FIRST OF ALL, MANAGEMENT IS OCCUPIED WITH ISSUES RELATING TO THE DISTRIBUTION OF INSURANCE PRODUCTS. WHO WILL DISTRIBUTE TOMORROW'S INSURANCE PRODUCT IS ON THE MIND OF EVERY CHIEF EXECUTIVE OFFICER IN THE INSURANCE INDUSTRY TODAY. A SECOND OPERATING ISSUE IS THAT OF AUTOMATION. SOME FEEL THAT THE KEY TO VICTORY IN THE FINANCIAL SERVICES RACE WILL BE AUTOMATION. THOSE SAME PEOPLE FEEL THAT BANKS AND BROKERAGE FIRMS ARE AHEAD OF THE INSURANCE INDUSTRY IN THIS REGARD. A THIRD AND MOST IMPORTANT OPERATING ISSUE FOR INSURANCE COMPANY CHIEF FINANCIAL OFFICERS IS COMMERCIAL LINES PRICE ADEQUACY. THE EXTENSIVE PRICE WAR I MENTIONED EARLIER LEFT INSURERS IN A POSITION WHERE THEIR PRICES STILL ARE SUBSTANTIALLY LOW AND ARE IN NEED OF STRONG, RAPID AND SUBSTANTIAL INCREASES. THIS HAS BEGUN IN 1985 BUT IT IS NOT YET CLEAR WHETHER PRICE INCREASES HAVE BEGUN IN TIME TO KEEP SOME LINES OF INSURANCE AFFORDABLE OR EVEN AVAILABLE AT ANY PRICE. AGAINST THIS BACKDROP, PRIVATE INSURORS DESIRE TO INSURE NEW CLASSES OF LARGE, POTENTIALLY HAZARDOUS RISKS MAY BE AT AN ALL TIME LOW!

EARLIER, I CHARACTERIZED THE FINANCIAL INSTITUTION INDUSTRY AS BEING IN TURMOIL. I THINK WE CAN NOW CONCLUDE TO ASSOCIATE TURMOIL WITH MY INDUSTRY ALSO! PERHAPS WE SHOULD EVEN CAPITALIZE THE T.

BEFORE CONCLUDING MY COMMENTS REGARDING THE PRACTICALITY OF PRIVATE CARRIERS INSURING DEPOSITS, I SHOULD SPEAK FOR A MOMENT REGARDING THE INTERNATIONAL SCENE. ONE OF THE ALLEGED BENEFITS OF MY JOB IS TO TRAVEL TO MEET WITH INTERNATIONAL REINSURERS. ON MY LAST TRIP TO LONDON THE HEADLINES IN THE LONDON PAPERS THE DAY I ARRIVED READ "SAVINGS PANIC HITS AMERICA". ONE, NOW WELL KNOWN, OHIO INSTITUTION DEALING WITH ONE, NOW EVEN BETTER KNOWN, GOVERNMENT SECURITIES BROKER LED TO THAT HEADLINE. THE NEWSPAPER WAS PUBLISHED IN WHAT MOST PEOPLE REFER TO AS THE INSURANCE CAPITAL OF THE WORLD. I SPENT THE OPENING PORTION OF THIRTY MEETINGS REASSURING REINSURERS THAT THIS INSTITUTION'S DEALINGS DID NOT, IN FACT, TRIGGER A "SAVINGS PANIC". FURTHERMORE, I ASSERTED THAT, IN THE END, THE UNITED STATES FINANCIAL INSTITUTION SCENE WOULD BE BETTER, NOT WORSE FOR THIS EXPERIENCE.

YOU MIGHT ASK WHAT IS SO IMPORTANT ABOUT THE INTERNATIONAL SCENE. INSURANCE AS WE KNOW IT TODAY IN THE UNITED STATES CANNOT EXIST WITHOUT THE PRESENCE OF REINSURANCE AND THE PRESENCE OF INTERNATIONALLY SUPPORTED REINSURANCE. IN PARTICULAR, COMMERCIAL LINES OF BUSINESS AND EVEN MORE PARTICULARY, LIABILITY LINES OF BUSINESS, FEATURING EXPOSURES WHOSE MAGNITUDE CAN ONLY BE DETERMINED OVER A LONGER PERIOD OF TIME, ARE EXTENSIVELY REINSURED INTERNATIONALLY.

THE QUALITY OF INTERNATIONAL REINSURANCE IS GENERALLY FELT TO BE HIGHEST AT LLOYD'S, FOLLOWED BY WESTERN EUROPE AND EASTWARD AROUND THE GLOBE UNTIL THE END OF THE ROAD SOMEWHERE IN SOUTH AMERICA. THE KEY SOURCE HAS TRADITIONALLY BEEN AND IS TODAY THE LLOYD'S SYNDICATES WHICH REPRESENT THE FULL AND UNLIMITED PERSONAL WEALTH OF THE APPROXIMATELY 30,000 INDIVIDUAL MEMBERS. SEVERAL COINCIDENT EVENTS ARE CAUSING GREATER PRESSURE ON LLOYD'S THAN AT ANY TIME IN ITS HISTORY. LLOYD'S HAS SUFFERED SUBSTANTIAL AND NOTORIOUS LOSSES IN RECENT YEARS, SUCH AS THE COMPUTER LEASING LOSSES AND RECENTLY THE SATELLITE LOSSES. BUT PERHAPS NOTHING HAS HAD A GREATER IMPACT AS THE DETERIORATION OF THE EXCHANGE RATE BETWEEN THE POUND AND THE DOLLAR. LLOYD'S ABILITY TO SUPPORT UNITED STATES EXPOSURES MEASURED IN DOLLARS WITH ITS SURPLUS VALUED IN POUNDS STERLING HAS BEEN SUBSTANTIALLY REDUCED BY DETERIORATION IN RECENT YEARS. THE WORST DETERIORATION OCCURRED AT THE SAME TIME SUBSTANTIAL FINANCIAL INSTITUTION LOSSES HAVE APPEARED FOR COLLECTION AT LLOYD'S.

THE RECENT STRENGTH OF THE DOLLAR HAS CAUSED A GREATER THAN NORMAL DESIRE TO SEE A CRACK IN THE OVERALL UNITED STATES' STRENGTH. FURTHERMORE, THERE IS A GROWING UNEASINESS REGARDING THE OVERALL VITALITY, STABILITY AND LONG-TERM VIABILITY OF CERTAIN INDIVIDUAL INSTITUTIONS AND FINANCIAL INSTITUTION SUBSETS. ADDITIONALLY, THE CREDIBILITY, DIRECTION AND ABILITY OF FINANCIAL INSTITUTION REGULATION AT THE FEDERAL LEVEL IS INCREASINGLY SUSPECT IN INTERNATIONAL CIRCLES.

LET ME STOP AT THIS POINT AND SUMMARIZE. IT IS SIMPLY NOT PRACTICAL NOW NOR IN THE IMMEDIATE FUTURE TO THINK IN TERMS OF PRIVATE INSURERS AND THE REINSURANCE COMMUNITY PUTTING THE INSURANCE INDUSTRY'S SURPLUS BEHIND THE INSURANCE OF DEPOSITS IN UNITED STATES FINANCIAL INSTITUTIONS.

BUT ENOUGH OF PRACTICALITY. LET ME MAKE SOME OBSERVATIONS FROM A CONCEPTUAL VIEWPOINT. LET'S ASSUME FOR A MOMENT THAT THE BANKING INDUSTRY WAS IN ITS BEST HEALTH, THAT THE INSURANCE INDUSTRY WAS IN ITS BEST HEALTH AND THAT INTERNATIONAL WEALTH WAS ANXIOUS TO EXPLORE THIS NEW INSURANCE FRONTIER. HOW WOULD THEY VIEW THE PROSPECT OF INSURING DEPOSITS IN UNITED STATES FINANCIAL INSTITUTIONS?

ASSUMING THE INSURERS WERE ABLE TO COMFORT THEMSELVES WITH THE CONDITION OF THE INDUSTRY AND THE ADEQUACY OF THE EXAMINATION AND REGULATION PROCESS, THEY WOULD HAVE TO ADDRESS THEMSELVES TO THE OTHER, MORE TRADITIONAL ASPECTS OF AN INSURER RELATIONSHIP. THIS WOULD INCLUDE ESTABLISHING UNDERWRITING GUIDELINES, INSURANCE LIMITS, CANCELLATION RIGHTS, DEDUCTIBLES, THE RATE TO BE CHARGED FOR THE INSURANCE, THE TIMING OF THE PAYMENT OF THE PREMIUM, AND SO FORTH.

LET ME FOCUS ON THE MORE IMPORTANT OF THESE ASPECTS. IF TRADITIONAL PRIVATE INSURANCE IS TO BE A VIABLE CONCEPTUAL ALTERNATIVE, THERE WILL NEED TO BE AN ABILITY TO UNDERWRITE. THAT IS, INSURORS WILL NEED TO BE ABLE TO SELECT ENTITIES TO INSURE WHICH MEET ACCEPTABILITY STANDARDS. SUCH STANDARDS ARE DETERMINED BY PROJECTIONS OF FUTURE LOSSES EXPECTED TO ARISE OUT OF SPECIFIC EXPOSURES OR RISKS INSURED TODAY AT A RATE CHARGED TO YIELD AN ACCEPTABLE PROFIT OVER TIME. IF AN INSUROR CANNOT UNDERWRITE, HE CANNOT PRICE. IT APPEARS THAT EVEN WITH ALL THE RESOURCES OF THE GOVERNMENT APPLIED TO DEPOSIT INSURANCE AND FINANCIAL INSTITUTION VIABILITY OVER THE YEARS, THERE IS A BROAD CONSENSUS THAT THE FUNDS ARE BANKRUPT.

HISTORY IS TELLING US THAT THE VERY SAME REGULATOR SET WHICH DICTATES THE OPERATING BEHAVIOR OF THE FINANCIAL INSTITUTION SET AND AT THE SAME TIME

COLLECTS DEPOSIT INSURANCE FROM THESE SAME FINANCIAL INSTITUTIONS HAS BEEN UNABLE TO UNDERWRITE DEPOSIT INSURANCE TO AN ACCEPTABLE "PROFIT" OVER TIME. IT IS UNLIKELY PRIVATE INSURORS WOULD EVER HAVE AVAILABLE THE FULL RESULTS OF EXAMINATION FINDINGS MUCH LESS BE AUTHORIZED TO DICTATE OPERATING BEHAVIOR OF THE DEPOSIT TAKERS. FRANKLY, IT IS NOT EVEN CONCEPTUALLY FEASIBLE TO THINK OF THE PRIVATE INSURANCE MECHANISM REPLACING THE FEDERAL DEPOSIT INSURANCE MECHANISM IN PLACE TODAY.

FURTHER COMMENT COULD BE OFFERED REGARDING TECHNICAL ASPECTS OF WHAT MIGHT BE A CONCEPTUALLY VIABLE ALTERNATIVE. BUT I HAVE TO SAY THAT, CERTAINLY FROM A PRACTICAL STANDPOINT AND IN ADDITION FROM A CONCEPTUAL STANDPOINT, I DON'T THINK WE CAN GET THERE FROM HERE. I DON'T THINK WE WILL SEE A TIME IN THIS CENTURY WHEN THE BANKING AND INSURANCE INDUSTRIES ARE IN PRISTINE CONDITION AND WHEN INTERNATIONAL REINSURANCE MAY BE ABLE TO EXPLORE THIS FRONTIER.

WELL, WHERE DO WE GO FROM HERE? THE OHIO SITUATION CLEARLY POINTED OUT THAT WITHOUT FULL AND UNLIMITED BACKING OF SOMEONE PEOPLE TRUST, "RUNS" ARE ONLY A MOMENT AWAY. TODAY, I BELIEVE PEOPLE TRUST THE FEDERAL INSURANCE CONCEPT. IT IS IMPERATIVE THAT DEPOSITOR TRUST BE EVEN STRONGER IN THE FUTURE SO THAT WHEN THEY INVEST THEIR MONIES IN A SAVINGS ACCOUNT, THEY SLEEP IN THEIR HOME AND NOT ON THE SIDEWALK! THE PICTURE OF A LINE OF PEOPLE OUTSIDE A FINANCIAL INSTITUTION WAITING TO WITHDRAW FUNDS NEEDS NO TRANSLATION TO BE UNDERSTOOD ALL AROUND THE WORLD.

I BELIEVE THE WAY WE GET THERE FROM HERE IS TO DO TWO THINGS. FIRST, LET'S NOT FIX IT IF IT IS NOT BROKEN. BY THAT I MEAN, SOME ASPECTS OF THE PRESENT SYSTEM WORK VERY WELL INDEED FOR THE INTERESTS OF THE MAJORITY OF DEPOSITORS. SUDDEN MOVEMENT TO A VARIABLE RATE FROM TODAY'S FIXED RATE, DRAMATIC CHANGES IN SUBROGATION STRATEGIES BY DEPOSIT INSURERS, AND OTHER SUCH ACTIONS TO SOLVE TODAY'S PROBLEMS MAY CAUSE GREATER EXPOSURES TOMORROW.

SECOND, SEVERAL YEARS AGO WASHINGTON WAS STRUGGLING WITH AN ANALOGOUS PROBLEM. FOR DECADES, MOST OF OUR CITIZENS HAD GROWN TO LOOK TO THE SOCIAL SECURITY SYSTEM AS THE MAJOR SOURCE OF THEIR RETIREMENT BENEFITS. WE ALL REMEMBER THE REASONS SUGGESTED FOR DETERIORATING CONFIDENCE. SOME CITED DEFICIENT ACTUARIAL PROJECTIONS, OTHERS CITED RUNAWAY INFLATION AND ITS ATTENDANT IMPACT ON THE COST OF LABOR, OTHERS SAID THAT IT WAS "NEVER INTENDED TO BE THAT IN THE FIRST PLACE", WHILE YET OTHERS SAID ALL OF THE ABOVE.

WHATEVER THE CASE, THE WAY WE BEGAN ADDRESSING THAT PROBLEM MAY PROVIDE A WAY TO GET THERE FROM HERE IN OUR DEPOSIT DILEMMA. MOST OF US ARE NOW FUNDING OUR OWN RETIREMENT BECAUSE THE FEDERAL GOVERNMENT MADE IT ATTRACTIVE FOR US TO SET ASIDE "OUR OWN" MONEY IN INDIVIDUAL RETIREMENT ACCOUNTS AND KEOGH ACCOUNTS. IN ADDITION, OTHER PLANS HAVE APPEARED, ALLOWING INDIVIDUALS TO SET ASIDE ADDITIONAL PRE-TAX DOLLARS. OVER THE NEXT TEN TO TWENTY YEARS THE AGGREGATE AMOUNT OF MONEY INDIVIDUALS WILL BE ABLE TO SET ASIDE TO SUPPORT THEMSELVES WILL GROW TO THE POINT WHERE THEIR SOCIAL SECURITY CHECK WILL REPRESENT A SMALLER AND SMALLER ELEMENT OF THEIR OVERALL RETIREMENT INCOME PLAN.

I BELIEVE THE WAY WE GET THERE FROM HERE AS IT PERTAINS TO DEPOSIT INSURANCE IS TO ESTABLISH A SIMILAR SET OF MECHANISMS AND INCENTIVES FOR INDIVIDUAL UNITS SO THAT THEY HAVE THE ABILITY TO INFLUENCE THEIR OWN DESTINY IN A FASHION SIMILAR TO THAT RECENTLY INITIATED WITH SOCIAL SECURITY.

HOW DO WE DO THAT? WELL, HERE ARE SOME ROUGH IDEAS:

1. DEVISE A PLAN WHEREBY OVER A REASONABLE AMOUNT OF TIME, SAY TEN TO FIFTEEN YEARS, FEDERALLY INSURED INSTITUTIONS TAKE ACTIONS TO ESTABLISH THE INDEPENDENT ABILITY TO BE GUARANTORS OF AN INCREASING PORTION OF THEIR OWN DEPOSITS. THE PLAN WOULD LIKELY INCLUDE A PHASE DOWN OF THE LEVEL INSURED BY THE GOVERNMENT FUNDS.
2. ESTABLISH A RATING AGENCY TO RATE INSTITUTIONS ON AN APPROPRIATE SCALE WITH THE HIGHER RATED INSTITUTIONS ELIGIBLE FOR HIGHER RATES OF LIABILITY GROWTH AND THE LOWER RATED INSTITUTIONS UNDER PRESSURE TO IMPROVE THEIR RATING OR BE PRECLUDED FROM GROWTH. A.M. BEST RATES INSURORS IN A FASHION WHICH MIGHT PROVIDE A STARTING POINT.
3. WEIGHT RATINGS BASED ON SUCH OPERATING CHARACTERISTICS AS CAPITAL RATIOS, LOAN LOSS RESERVE ADEQUACY, RECENT EXAMINATION FINDINGS, ETC.
4. PHASE IN OF SELF-INSURING WILL LIKELY REQUIRE EACH INSTITUTION TO FUND A CONTINGENCY RESERVE TO COVER PROBABLE FUTURE EVENTS. SUCH A CONTINGENCY RESERVE MIGHT EXIST WITHIN EACH INDIVIDUAL INSTITUTION OR AS A FREE-STANDING POOL SIMILAR TO THE GUARANTEE FUNDS FOUND IN THE INSURANCE INDUSTRY TODAY.
5. REQUIRE REGULAR INCREASES IN CAPITAL BASED ON THE NATURE OR EXTENT OF BANK OPERATIONS.
6. UNDERTAKE A CAMPAIGN TO BROADEN DEPOSITOR UNDERSTANDING OF UNINSURED DEPOSITS SO THAT WHEN THE INSURED LEVEL DECREASES, THE MARKET CAN MAKE INTELLIGENT DECISIONS.

7. EXPLORE PRIVATE INSURANCE AS A MECHANISM TO PROTECT SOME OR ALL OF THE EXPOSURES THAT SOME OR ALL DEPOSITORS MIGHT HAVE CONCERNING SOME OR ALL OF THE CONDITIONS LEADING TO THEIR LOSING SOME OR ALL OF THE PRINCIPAL OR ACCRUED INTEREST.
8. CONSIDER A SYSTEM WHERE DEPOSITORS PURCHASE THE INSURANCE RATHER THAN HAVE THE FINANCIAL INSTITUTION ACTING AS THE INTERMEDIARY BETWEEN THE DEPOSITOR AND INSURER.

I WOULD CLOSE BY ASSERTING THAT, IN MY OPINION, THERE MAY WELL BE A ROLE FOR PRIVATE INSURANCE IN THE DEPOSIT INSURANCE ARENA IN YEARS TO COME. I BELIEVE THE ROUGH BLUEPRINT I OUTLINED TOWARD THE END OF MY COMMENTS HAS SOME POTENTIAL BUT NEEDS TO BE REDRAWN BY A DRAFTSMAN OR A GROUP OF DRAFTSPERSONS WHO CAN GIVE IT CONSIDERABLE THOUGHT AND WHO CAN SOLICIT INPUT FROM ALL DIRECTLY OR INDIRECTLY AFFECTED PARTIES.

MY COMPANY, CNA, HAS RECENTLY ADOPTED A PHRASE WHICH IT HAS INCORPORATED INTO OUR CORPORATE LOGO. YOU MAY HAVE READ IT IN OUR ADVERTISEMENTS OR HEARD IT ON OUR RADIO CAMPAIGNS. THE PHRASE IS "FOR ALL THE COMMITMENTS YOU MAKE". THE BANK AND THRIFT INDUSTRIES ARE IN A PERIOD OF TURMOIL AND MAY BE APPROACHING ONE OF THOSE CRITICAL JUNCTURES IN HISTORY WHEN DETERIORATION ACCELERATES OR A TURNAROUND OCCURS. THAT'S WHERE COMMITMENT COMES IN. IT IS IN EVERYONE'S INTEREST THAT WE COMMIT OURSELVES TO IMPROVING THE CONFIDENCE PLACED IN FINANCIAL INTERMEDIARIES BY BETTER PROTECTING CITIZENS' INVESTMENTS, THEIR DEPOSITS.

Chairman **St Germain**. Thank you, Mr. Lumpp, for an excellent statement. I wish some of our previous witnesses had been here to hear your statement. I think it would have been a lot of fun.

Mr. **Lumpp**. Thank you.

Chairman **St Germain**. It certainly would have been illuminating.

I received a summary, Mr. Huertas, of your study and, on page 2, it said:

> With these safeguards of the payment system in place, the modified payoff approach can be applied in any bank failure regardless of size. Thus, under a modified payoff approach, no bank would be too big to fail. This is fair to banks, fair to depositors and fair to the FDIC.

I guess I read this on one of my flights between Rhode Island and here. I underlined that and I put down next to it, "I am not convinced."

I made some other notes as well. But I just wanted you to know that we did read and take note of your suggestions and your study.

Mr. **Huertas**. Yes, sir.

Chairman **St Germain**. Mr. Eisenbeis, you made reference during your discussion of subsidiaries and affiliates to the fact that it would require that the regulators be competent and adequately informed to supervise or examine those affiliates.

Am I quoting you correctly?

Mr. **Eisenbeis**. That's a logical implication of my position, yes.

Chairman **St Germain**. Now, let me tell you where I'm troubled—that is that listening to testimony during hearings on Golden Pacific, the USNB of San Diego, Continental, one thing came through loud and clear, as well as from the testimony of the regulators and their representatives to date before this subcommittee, and that is that the turnover rate is a big problem. As soon as these people become adequately informed and have an expertise, the next thing you know a very wise financial institution comes along and says, "Hey, how much are you making? We can pay you twice that."

Then they're gone. The average life of some of these examiners is between, I think, 3 and 5 years.

So that really would trouble me. I think it should give you cause for concern as well when one considers your testimony and your analysis.

Now, do you think, Professor Eisenbeis, that subordinated debt and modified playoffs is the answer to this problem that we're facing today? Does it answer the problem of the big bank, of the fail safe bank?

Mr. **Eisenbeis**. I think——

Chairman **St Germain**. One more question I would like to pose here is that testimony to date has indicated that subordinated debt is great for the big banks, but the little banks would probably have a great deal of difficulty finding anyone to purchase their subordinated debt or to invest in for that manner.

Now, proceed.

Mr. **Eisenbeis**. I think that we have to do something to break this perception that large banks are too big to fail. We have to find a way of not liquidating them, but a way of keeping them in operation, recapitalizing those institutitions that may be too large to liquidate, put them back on their feet again, sell them to the marketplace, or whatever, and impose costs on the creditors of those institutions.

And I think the modified payout is an important way to go about that. Subordinated debt is also a potentially useful element because it provides a bigger cushion. And it provides additional protections to the FDIC. It potentially lowers monitoring costs, and it increases market discipline that would result also.

I think, however, that we also need to go, as I indicated in my testimony, to risk base deposit insurance premiums. We need to charge for the risks that would be shifted to the FDIC and the insurance agencies as a whole.

But I would certainly give strong support to the idea of the modified payouts and the subordinated debt.

As far as the small banks are concerned, I know there's been a great deal of skepticism on their part that they just wouldn't be able to sell subordinated debt. My own position would be that, if we were going to move to a system that would require increased capital, whether you do it in a form of equity or subordinated debt is not something that I particularly care about. The same amount of protection would be there in either case. And I would just——

Chairman ST GERMAIN. Excuse me, Professor. The concern was not expressed by the smaller banks. They haven't testified yet.

Mr. EISENBEIS. Oh, well——

Chairman ST GERMAIN. The concern was expressed by some of your colleagues from academia and think tanks.

Mr. EISENBEIS. Oh, well, I guess I would enforce higher capital standards for smaller institutions that is, giving them the option of either using subordinated debt or equity. And we know that profitable, the smaller institutions, have ways of raising equity, and they've traditionally had higher capital to begin with. The capital adequacy problems typically tend not to be with the smaller institutions anyway. So I wouldn't force them to raise subordinated debt if they have a less costly and potentially preferred option which may be equity.

Chairman ST GERMAIN. How about the question of whether financial institutions should pay FDIC insurance on their foreign deposits, or should those be exempted?

Mr. EISENBEIS. I have got two answers on that.

Under the present system——

Chairman ST GERMAIN. You are not an economist, are you? [Laughter.]

Mr. EISENBEIS. Yes.

Chairman ST GERMAIN. We get multiple answers from economists.

Mr. EISENBEIS. Under the present situation that we have with Continental, there was a 100-percent guarantee of the liabilities of that institution. I don't think there is any question that since the FDIC was potentially picking up all of the risks associated with all of the liabilities of that institution that clearly premiums should be levied on the protected liabilities, in this particular case all the liabilities of the company. Logically, that would include the foreign deposits of the money center banks at this point.

If we move to a system where, as has been suggested, we strictly only insure deposits up to a certain level, then we want to distinguish between the rate that we charge for the coverage that is being granted, from the base on which that rate is levied, and by that I mean if we have a situation where we have a bank that has $1 of insured deposits and a million dollars of uninsured liabilities there in fact is potentially $1 million of assets and $999,999 other liabilities that will run off before we have to worry about the resources to pay off that $1 of insured liabilities.

Under that particular case, the total risk as far as the insured liabilities are concerned is relatively small. That institution would have a small premium.

But it is the risk of the entire entity relative to the amount of potential liability that the FDIC would have that is the important element.

Chairman **St Germain**. Let me see if I can interpret your reply.

Mr. **Eisenbeis**. OK.

Chairman **St Germain**. It was very academese, and don't get me wrong, I mean, we have——

Mr. **Eisenbeis**. Sure.

Chairman **St Germain**. That is why we are here. We respect you.

But are you saying that—well, let me rephrase here a little bit and see if I interpret it correctly—let's say in the case of a money center bank, if we went to modified payoff and subordinated debt, made it very clear that if an institution fails uninsured depositors are not going to receive any return and that we will shutdown or, as you said, put into a trusteeship that large bank, then the stockholders are going to take a bath, they are going to lose everything, and the people who have the subordinated debt, they too will lose everything. That means that those sophisticated foreign depositors who have been depositing in those foreign branches know full well they are on notice now that they are going to lose everything.

How many of those sophisticated foreign depositors, if that is the scenario we build—if we were to take the suggestion of Mr. Huertas and say, yes, there will be no more Continental failsafe banks, from now on anybody can fail, how many of those sophisticated foreign depositors would want to deposit in a money center bank, a large money center bank's foreign branches, knowing full well that their deposits are uninsured?

Mr. **Eisenbeis**. Well, I think——

Chairman **St Germain**. Interesting question, isn't it?

Mr. **Eisenbeis**. No, I think that the answer is that those foreign depositors who see healthy and well-managed money center banks will be quite willing to put their funds in the money center institutions. They will not be willing to put their funds in those that are highly risky, and if they do they will require a much higher rate of return as a result. So they will have to be compensated for their risk.

Right now we have a situation where they think they are being 100 percent insured, so they have no incentives to monitor what the institutions are doing.

Chairman **St Germain**. Last question, then I will go to my colleague.

Mr. **Eisenbeis**. Sure.

Chairman **St Germain**. Is there anyone on this panel right now who can definitely state that if another Continental Illinois comes about, whether or not there is modified payoff, subordinated debt, risk-related premiums, et cetera, et cetera, that the regulators once again will say, my God, there are 1,800 communities, there are 5,000 banks, there are 7,000 major corporations that will fail, go bankrupt if we impose the penalties that we are supposed to impose in this instance? Do you really think that we can find the solution to that one and that we are going to allow those many banks, those communities, those corporations to fail along with the large banks?

Mr. **Eisenbeis**. Well, to speak for myself, I think the modified payout and trustee arrangement goes a long way toward making that less likely because you are not talking about liquidating those institutions. You are preserving that money center or other large institution as an operating bank.

Chairman **St Germain**. And they would get a percentage of it?

Mr. **Eisenbeis**. That is right. So people don't lose everything, just a little bit.

Chairman **St Germain**. They would get a percentage of it; right?

Mr. **Eisenbeis**. Right.

Chairman **St Germain**. You don't think the regulators would say, well, that percentage isn't enough because too many thrifts, for instance, who are in bad shape already, would fail?

Interesting question.

Mr. **Eisenbeis**. It is hard to put yourself in that position.

Chairman **St Germain**. Yes.

Mr. **Eisenbeis**. The temptation on their part would be to try to avoid incurring those costs, but I think it is wrong.

Chairman **St Germain**. Yes, very good.

Mr. Wylie.

Mr. **Wylie**. Thank you, Mr. Chairman.

I would like to follow up on that line of questioning with Mr. Huertas, and I need to understand your position when you say that no institution is too large to fail.

That concept came about after the *Continental Illinois* case, of course, and what would you have done, in hindsight here, as far as Continental Illinois is concerned?

FDIC was faced with a real bad problem, and they made a decision. Since then they have come up with the so-called modified payoff plan, which is not too dissimilar from the one you have suggested. But at the time they didn't have one like that.

What would you have done in the *Continental Illinois* case?

Mr. **Huertas**. It is difficult to second guess at this stage and to say that on the day of May 18, 1984, which I believe was the day of the crisis, that some other course of action should have been taken.

I believe that the regulators felt that it was a prudent course of action to take the steps that they did. They felt that not saving the Continental would have produced some type of panic.

I don't mean to go back and second guess and say they should have done something different in that situation. That is past, and for better or for worse we cannot change that.

What I do mean to say is that these actions should not be a blueprint for future policy and that the time is now for the Congress to make clear that the regulators should find some way, some other way out of the crisis, such as the modified payoff and the trusteeship, and indicate strongly that this is the preferred or, indeed, the only solution to the problem of a failed bank.

I believe that the regulators, in particular the Federal Reserve, have it within their power and ability to safeguard the banking system. That is what the Federal Reserve was created for, to safeguard the banking system, not to safeguard each and every individual bank.

Insolvent banks should be allowed to fail, and that would be the recommendation for the future.

Mr. WYLIE. Now, under your modified—we are thinking along the same lines here this morning. Now, let's assume your modified payoff plan didn't work. The uninsured depositors, there wasn't enough to give them anything. They wouldn't get any immediate payment.

Is that your plan, that uninsured depositors would receive some immediate payment?

Mr. HUERTAS. Yes, that is correct, that under the modified [illegible]off the FDIC would make an estimate of the probable future re[illegible] from the assets of the bank. On the basis of past workouts [illegible] banks, in most cases they have recovered well in excess of [illegible] on the dollar, so that the uninsured depositor, after all is [illegible] done, would have incurred a loss of less than 10 cents on the dollar.

This indicates that there is considerable opportunity for the FDIC to make an immediate payment or make available immediately a significant proportion of the uninsured deposits to the depositor.

Mr. WYLIE. Well, I know these are all hypothetical right now. I hope we don't have a situation coming up like this, but let's assume they made an estimate that they couldn't make it, that they didn't have any money, they didn't have 90 percent under the modified payment plan available in short. Let's assume it is a savings and loan. There are some savings and loans where they are just simply not going to get that much out of it.

What do you do in a case like that?

Mr. HUERTAS. We have not studied in detail the situation of the savings and loan industry and the condition of the FSLIC, so I would not be prepared to make a specific statement with respect to the savings and loan industry.

With respect to commercial banks, however, particularly large commercial banks, the record over time has been that these banks have been closed when they are very close to insolvency, so that the recovery proportion has been very high except in those few instances—or rather except in instances where fraud is involved. In those cases losses may be greater. But even in cases of fraud recovery has usually been well in excess of 50 cents on the dollar.

Mr. WYLIE. Thank you.

Mr. Eisenbeis, you suggest some sort of a method of risk-related insurance, as I understand it, but not based on the deposit, is that right?

I rather favored risk-related insurance at the outset. It wasn't necessarily an idea that I came up with, but Chairman Isaac came up with the idea and Mr. Gray came up with the idea of why should an institution which is properly managed be made to insure the risk of an institution where there are some high flyers and risk takers?

Mr. **Eisenbeis**. Well, I am definitely in favor of risk-related changes for insurance.

Mr. **Wylie**. And then how would your risk-related plan work again?

I listened to your testimony carefully, but——

Mr. **Eisenbeis**. I didn't really talk about that issue in the prepared testimony. I don't really see too much difference between risk-related premiums and risk-related capital standards.

Mr. **Wylie**. You talk about a risk-adjusted capital standard.

Mr. **Eisenbeis**. Right.

What I would envision the agency would do, would be to make a determination about the risk exposure of the institution as a whole, taking into account credit quality, interest rate risk exposure, operations risk to the extent possible, looking at balance sheet items, and then adjust the capital ratio in connection with that.

Mr. **Wylie**. Excuse me just 1 minute. You talked about, in the case of the ag loans—it might have been you—that they had one rotten egg in the barrel, or the basket, and therefore it would possibly be better if they were able to diversify.

Isn't it possible that they might get more rotten eggs in the basket, there might be a hockey team in there or a fast food chain or something, you know?

Mr. **Eisenbeis**. When I was talking about using that analogy, it was clustering all of their lending activities in one particular industry, and if something happened to that industry then in fact they would be in grave difficulty. Institutions could diversify their lending over into housing, into other kinds of loans, and so on, and you wouldn't have that problem.

Mr. **Wylie**. Now, when you talk about your risk-adjusted capital standard, you are not talking about relating it to the degree of concentration of loans in a particular industry?

Mr. **Eisenbeis**. That would have to be one dimension. How diversified the company was would affect the probability that the institution would get into financial difficulty, which should be associated with a higher or lower charge for their premiums.

Mr. **Wylie**. So maybe ag banks ought to be charged a higher premium then?

Mr. **Eisenbeis**. Because they are not diversified, that is right.

Mr. **Wylie**. OK. I won't interrupt again.

Mr. **Eisenbeis**. That is fine.

Mr. **Wylie**. Explain your risk-adjusted capital——

Mr. **Eisenbeis**. The point I wanted to make was that it is not deposits that are at risk, it is the insurance agency that is at risk because of the activities the institution is engaged in. The amount of risk that the insurance agency faces is related to what its potential liabilities are as well as the probability that the institution would get into financial difficulty. Both of those elements would determine what the total cost of insurance should be to that particular entity.

Mr. **Wylie**. OK. You talked in terms of savings and loans and the risks that they have with reference to housing.

As a general proposition, isn't investment in real estate less risky than some of the other activities that they are now investing in?

Mr. **Eisenbeis**. As I tried to indicate, the critical element in assessing what the risk implications of expanded powers are is not solely related to what the risk of a particular activity is in isolation but how it relates to what the companies are doing in total. You can have situations where an entity can be investing in a market basket of activities each of which would appear in isolation to be very risky. But because the pattern of the cash-flows offset the cash-flows that are in that basket already, the total portfolio is less risky than it otherwise would have been.

We really need to focus on what happens to the overall risk exposure of the institution, firm by firm, as a new activity is added to its portfolio and complement of activities.

Mr. **Wylie**. Mr. Huertas, I didn't quite understand your idea that deposits overseas should not be insured.

Wouldn't you be more likely to get deposits from people overseas if they knew their deposits were insured? Wouldn't that be a good incentive to get money into the system from overseas?

Mr. **Huertas**. I don't believe so, sir. I think the cost to the system would be high, and that the cost potentially to the bank would also be high.

We believe that Citicorp and Citibank is a strong, well-managed, low risk bank and that we would prefer to compete for deposits on the basis of the strength of our own institution without having any type of the guarantee of the Federal Government behind it. We would like to distinguish ourselves from other institutions and compete against other institutions on that basis.

As a public policy matter, I would remind you that some of our—some of Citibank's deposits in foreign countries are in pounds sterling, German marks.

These depositors are German residents in Germany, and at least my reading of the original intent of the legislation was that it was quite clear that the program was intended to benefit the American, the average American, and not to protect the resident of Germany, who would be protected to the extent that Germany feels it necessary by the laws of his own country.

Mr. **Wylie**. Well, the chairman has been generous and I have used more than 5 minutes, but I thought maybe insuring foreign deposits might increase the amount of money coming to the FDIC Fund by broadening the base. I was looking at it from that standpoint.

Mr. **Huertas**. We don't believe that an increase in the fund is necessary. We believe that the FDIC should be protected by the regulatory and supervisory process to close down banks when they are insolvent. This will limit the exposure to the fund.

We also believe that the implementation of the modified payoff will enable the FDIC to benefit from the coinsurance provided by uninsured depositors and will limit any exposure to loss that the FDIC might have.

Mr. **Wylie**. Thank you.

Chairman **St Germain**. I'm not going to ask a question, however, I'll make an observation. Maybe I'll ask of you later, but in view of the fact that you just said that the bank, you mentioned the insolvency—oh, if insolvent banks are promptly closed, the FDIC experiences only minimal losses, et cetera.

Do you recall that, in your study?

Mr. **Huertas**. Yes, sir.

Chairman **St Germain**. Well, for those of us who have been on the committee a while, you'd be amazed at the number of people who have contacted us through our colleagues who are not on the committee, saying:

The FDIC or the FSLIC is coming in. They're shutting us down and we are not insolvent.

How would Citibank like it if the FDIC came in or the comptroller, and said, you are insolvent?

Would you then go to court, or what? Think on that. We'll get back to you later on. A lot of people have been burned. You know, what might be beautiful to one person, to the beholder, another beholder thinks is ugly.

Mr. Parris.

Mr. **Parris**. Thank you, Mr. Chairman, just a couple of brief questions.

Mr. Huertas, in your insertion here—excuse me, the report, entitled "Deposit Insurance Overhaul or Tuneup," on page 3, it indicates, among other things:

"Other factors hold risktaking by banks in check. There is self-discipline by shareholders and management."

And my question is, with 120 percent of the capital of your bank in an extension of credits in international markets to one nation, is that, in your opinion, self-discipline by management?

Mr. **Huertas**. It is self-discipline. We have no collection of credits to borrowers in any single nation exceeding our capital. Those figures of 120 percent of capital are all developing countries taken together.

We believe that these loans will be repaid over time. We are working with the IMF, with the governments here in the United States and overseas, and in the developing countries to work out the problems that developing countries are currently having in obtaining the foreign exchange necessary to repay these loans.

I feel that we have behaved prudently in managing our exposure and we continue to closely monitor the exposure.

We do not deny that there are risks involved but we do contend that we are managing those risks prudently.

Mr. **Parris**. Certainly, the extension of credits has largely been based on the fundamental premise that's assumed for years: Sovereigns don't default, big banks don't fail.

Is that not correct?

Mr. **Huertas**. I don't believe that is correct.

Mr. **Parris**. You've said in your testimony that big banks can and should be permitted to fail.

Mr. **Huertas**. Yes; that's correct, and that's what it says.

Mr. **Parris**. And I think we have seen, will see increasingly, that sovereign nations can and do default.

Is that not a matter of concern to those that have extensions of substantial credit amount?

Mr. **Huertas**. Yes; it is, obviously, a concern that foreign nations could place a moratorium on payments. They could delay payments. However, we would draw a distinction. The foreign nations are by no means bankrupt. The debt of developing countries, even countries with debt servicing problems, is on average less than 6 months of their income. The interest payments that they incur each year is equivalent to about 2 weeks of their income.

So they are by no means bankrupt in the sense that an industrial firm would be considered bankrupt, where its liabilities exceed its assets.

Mr. **Parris**. What if they take a position like Mr. Garcia in Chile, that indicates a limitation of payment? What if all of them took that position? What could we do about it?

Mr. **Huertas**. Well, first of all, we don't expect that all of them will take that position. And, indeed, the most—indeed, every country but Peru, even Cuba, that had recommended that everybody else repudiate its debts, in its own instance has taken measures to keep its debt service payments current and to reach an agreement with its creditors. And countries do this because they wish to preserve their access to the international capital market.

And it's in their own self-interest to keep access to that market open. It is not in their self-interest to default.

Mr. **Parris**. You place a great deal of faith in the disciplining results of the modified payoff system, which I generally share your favor toward, Mr. Huertas. Possibly supplemented, if I understood your statement, by subordinated debt in order again to serve as a means of monitoring the bank management behavior.

But you seem to reject the risk-related approach, which seems to me that it clearly penalizes the more conservative managements in favor of the risk taking, as my friend from Ohio, Mr. Wylie, was talking about.

Would a system of risk-related premiums not encourage a market discipline of a sort by penalizing risk takers?

Mr. **Huertas**. It would not. I think there is a big difference between risk related, regulator imposed deposit insurance premiums and the differentiation that would occur in the marketplace among banks in attracting, and the rates that they would pay on uninsured deposits.

If you're going to price deposit insurance, it should be priced according to the risk to the insurer, and none of the proposals we have seen indicate that this will be done.

They do not take into account that the risk to the insurer is very much related to when you close down the bank. If you close down the banks at the point, or close to the point when they become insolvent, the risk to the insurer is very low, indeed minimal.

They do not take into account that there is a great deal of coinsurance provided by uninsured depositors. But, perhaps most importantly, and this is exemplified by the recent proposal of the FDIC, there is a single body that imposes a risk-related premium to which there is no appeal and this is I think a step down the road of involving the officials in every aspect of the banking business.

Already in that proposal there is an indication that some years down the road this proposal will have to be refined, it will have to be made more precise, and greater differentiation will have to be made among the types of assets that banks acquire and the types of loans that they make.

I don't believe that this is the way the banking system should run.

You don't want the regulator looking over the banker's shoulder and second guessing every decision that the bank makes. What the regulator should do is let the banks make the decisions. If those decisions turn out to be so bad that the bank becomes insolvent, at that point, the bank should be shut down.

Mr. PARRIS. Well, I agree totally with your statement, but I'm not sure you and I come at the conclusion from the same direction. And I would pose the question academically.

After Continental Illinois, is there any such thing as an uninsured depositor?

Is there any such thing as a guaranteed creditor?

My time has expired, but thank you very much.

Chairman ST GERMAIN. Why don't we ask Mr. Huertas to answer that very erudite question?

Mr. HUERTAS. Well, as we point out in the paper, we do believe that there are effectively uninsured depositors today. I think one should draw a distinction between the insurance that was provided ex post, or after the fact, in the case of Continental, and ask whether that actually does imply, as many people seem to assume, that there is now de facto or actual or before the fact insurance of all of these deposits.

That is the common assumption in the press, but it is not shared in the marketplace. There is differentiation among banks in terms of the rates that they pay on deposits. Large depositors are reviewing banks and the condition of banks.

Rating agencies are coming in to rate banks. And if all deposits were actually de facto insured, and everybody had perfect confidence that all deposits were insured, you would not see any differentiation in rates. You would not see people reviewing very closely the institutions in which they place their funds; and nor would you see rating agencies trying to make a business out of rating different banks.

Mr. PARRIS. With the indulgence of the chairman, I would just add, if what you say is correct, we have certainly established some kind of a precedent, have we not, in the *Continental Illinois* case?

I mean, how do you avoid that?

Mr. HUERTAS. Well, I think there is the danger of precedent and in my testimony I have suggested a way out, and the way out being the modified payoff and the use of subordinated debt.

Chairman ST GERMAIN. Mr. Huertas, give me an example of depositors or creditors losing money as a result of a bank failure, other than Penn Square, which was larger than $500 million in assets.

Mr. HUERTAS. In this country?

Chairman ST GERMAIN. Of course this country. I know that Citibank is all over the world, but you see, I've just been out of this country twice so, I'm not too concerned.

Mr. Huertas. I cannot give you an example off the top of my head.

Chairman St Germain. You know why, don't you?

Mr. Huertas. It is probably because no example exists.

Chairman St Germain. Because there isn't any to give.

Mr. Huertas. But I would submit this is a dangerous situation for public policy in that this is the——

Chairman St Germain. I couldn't agree more. We all agree with you on that. Maybe you were busy on your study, but sometimes, if you'd like some exciting reading, if you are asleep and want to stay awake, I think we might find a copy of the hearings on Continental Illinois of interest.

Mr. Huertas. Well, I did start and I share your opinion of the high literary quality. [Laughter.]

Mr. Barnard. Thank you, Mr. Chairman.

Mr. Chairman, first, I want to certainly congratulate you on assembling this very fine group of witnesses this morning, and I apologize that I was late for the hearing. I had to attend a full committee hearing on Government Operations. And I missed much of the testimony and I don't have too many questions.

Dr. Benston, we're talking about deposit insurance reform. Do you think that we can move on one track which would incorporate the same changes in FDIC and FSLIC? Or, in trying to effect deposit insurance reform, are we going to have to move on two tracks?

Mr. Benston. I think that the basic problem, or the basic difference between the two situations is that there are a very large number of savings and loan associations that are economically insolvent. And the consequence is that asking them to put up additional capital would be not only very difficult, but in fact impossible because investors would not put their money into an insolvent situation by themselves.

At the same time, the risk is posed to the deposit insurance fund of managers and owners of insolvent institutions who can very easily and perhaps rationally take very great risks; as compared to the solvent institutions, which are many more in the case of commercial banks, most of them, maybe all of them, are solvent. One can require solvent institutions to put up additional capital, if it's inadequate, in the form of subordinated debentures or additional equities or double liability of stockholders, as was done prior to the forties, thirties, even up to the fifties.

And so the questions are really different. I suspect that for the savings and loans, the major problem is to allow them to diversify and to expand their activities, to earn their way out of their situation, and to close down those that are so hopelessly insolvent that they may be tempted to take very great risks; while that situation doesn't exist for commercial banks.

I think those are the major differences between them and, therefore, the solutions to them have to be different.

Mr. Barnard. Dr. Eisenbeis and Mr.—is it Huertas?

Mr. Eisenbeis. Yes, that's correct.

Mr. Barnard. There's been some suggestion that Congress did move too far in 1980 in increasing the coverage to $100,000. What kind of an impact would it be on banking if you say that you would guarantee 100 percent of transaction accounts? And then reduce the coverage on saving certificates and others?

What kind of an impact would that have on the commercial banking industry?

Mr. **Eisenbeis**. Well, I think it would have a couple of impacts. First of all, it would induce those people who value a large amount of coverage to shift their holdings of bank liabilities from the time deposit market into the transactions account market. And so there would be a shifting in the composition of liabilities toward potentially effectively shorter maturities, which would have some impact on asset and liability management capabilities.

For institutions that are close to the margin and quite risky and potentially in danger of failing, I would think that 100 percent insurance, if it were coupled with the ability to pay unlimited rates, would potentially enable them to go out and bid for funds in an attempt to "bet the bank," so to speak—to earn their way out of difficulty.

Mr. **Barnard**. Isn't that done today though? Especially the savings and loan industry? Aren't they out there bidding for money which——

Mr. **Eisenbeis**. I think that's part of the point that we can learn from the savings and loan industry. When you have a situation with improperly priced insurance and no limits on what institutions can pay, they can go out and bet the institution. As was pointed out, heads they win, tails the Government loses, because of the risk that they pose to the insurance fund.

Mr. **Barnard**. Well, you see, I think that's why we——

Mr. **Eisenbeis**. I just want to make one other observation, sir, that that's one of the reasons that I don't favor 100 percent insurance, but rather I think it is important to have a——

Mr. **Barnard**. I mean, wholly owned transaction accounts.

Mr. **Eisenbeis**. I know. I wouldn't even have 100 percent insured there.

Mr. **Barnard**. You wouldn't put——

Mr. **Eisenbeis**. No, sir.

Mr. **Barnard**. What about you, Dr. Huertas?

Mr. **Huertas**. I would agree with what Dr. Eisenbeis has said, that there is a danger that you would transform the present limited coverage of $100,000 into much more complete, possibly even 100 percent coverage. And I believe that is poor public policy, for the reasons that I outlined in my statement, and for the reasons that Dr. Eisenbeis has just mentioned.

It is a very significant change from the original intent of Congress in designing the deposit insurance system; namely, to protect the deposits of the average American.

Mr. **Barnard**. Well, let's get on the next step then. Both of you endorse risk-related premiums, I understand. Right?

Mr. **Huertas**. Excuse me, sir. No, I do not.

Mr. **Barnard**. You don't?

Mr. **Huertas**. I did not endorse that at all.

Mr. **Barnard**. Did you, Dr. Eisenbeis? You supported——

Mr. **Eisenbeis**. I supported that. I supported risk-related premiums.

Mr. **Barnard**. All right. But you did support the payout, the——

Mr. **Eisenbeis**. Yes, that's correct.

Mr. **Barnard**. The modified payout.

Well, let me ask you, Dr. Eisenbeis, who is going to determine the risk? You know, isn't that going to put a tremendous load on the regulatory agencies and is that going to be disclosed?

I mean, that sounds like a very good idea but when you get right down to the administration of it, isn't that going to be somewhat—now we've already seen on this committee that the regulatory agencies have their hands full. You know, we look at—I don't have to cite the examples. The examples are well-known to us. And I would believe today that if it weren't for the fact that 96 percent of the banks are well-managed and well-operated, that we would have a real calamity in the country.

So I say again, how much of a load are we putting on the insurance agencies and the supervisory agencies to determine what this risk is?

Mr. **Eisenbeis**. Well, I don't think we're putting that much of a load on them, simply because they're doing it already. They are evaluating institutions. They have a mechanism in place to supervise them. They come up with a risk ranking. They just don't put a price on that risk, once they've gone through the process.

So I don't regard the burden they'd be put to as being much greater. There would be a different kind of burden. That is, there would be a political burden. Institutions would try to hassle and haggle over their premium, claiming it was too high relative to others. But it seems to me that that's a cost worth incurring, relative to the situation that we find ourselves in now, where there's nothing to penalize risktaking.

I think we're talking about a system that would be admittedly imperfect to begin with, but clearly a step in a direction that would be much more positive than where we are now.

Mr. **Wylie**. Would the gentleman yield, please.

Mr. **Barnard**. Yes, sir.

Mr. **Wylie**. Mr. Eisenbeis, you mentioned that nearly two-thirds of the bank failures are due to fraud and insider dealings.

Mr. **Eisenbeis**. Yes, sir.

Mr. **Wylie**. Rather than other problems, and Mr. Huertas suggested that maybe market discipline could control bank risk-taking activity.

To what extent did market discipline prevent losses due to fraud or insider abuse? And isn't that something we ought to take into account?

Mr. **Eisenbeis**. I think that that's a very insightful observation that you've made. I don't think that market discipline does too much to prevent people from committing fraud. It's astounded me that the agencies haven't devoted more attention in restructuring their examination policies and procedures, particularly with their in-house inspections, to try to get at that particular problem.

I worked at the FDIC and the Fed in my career, and it is just simple economics that you direct your resources into those areas where you're going to be incurring the greatest potential losses. It's quite clear to me that, aside from the depression, the greatest losses have always been due to fraud and the agencies are not doing what they could and should be doing to try to detect and monitor and police those problems. They really need to reorient their supervisory examination policies.

Mr. WYLIE. Do you address that in your paper, Mr. Huertas?

Mr. HUERTAS. The question of market discipline and the effect on fraud?

Mr. WYLIE. Yes.

Mr. HUERTAS. No, not specifically, but let me say that I believe it would have some impact, that the uninsured depositors would and do recognize that fraud is a possibility and that fraud could cause them to lose some money. They will demand information, indeed, they do demand information about the audit procedures at a bank, about the record and the past activities of the management of the bank, and they do make judgments regarding the probity of the individuals running the bank. So that there is some discipline. Market discipline will look to the question of fraud.

Mr. WYLIE. Thank you for yielding.

Mr. BARNARD. My time is expired, but I might say that in Maryland with State private insurance, there weren't many questions asked.

Mr. HUERTAS. I think in that particular situation, sir, there was an assurance given of 100 percent insurance, and that this illustrates the very dangers that we're talking about.

Mr. BARNARD. We're giving that assurance today that doesn't exist. We give the assurance today that—and as it's been brought out—that we're insuring depositors 100 percent.

Chairman ST GERMAIN. How does that, Mr. Huertas, answer Mr. Barnard's question and the question of Mr. Wylie, with relation to fraud?

Mr. HUERTAS. The insured——

Chairman ST GERMAIN. Was there not fraud in Maryland? Does it not appear that there was fraud in Maryland and in Ohio?

Mr. HUERTAS. From what I have read in the papers, it appears that fraud may have been involved.

Chairman ST GERMAIN. Uh-hum.

Mr. HUERTAS. I think it is——

Chairman ST GERMAIN. Let's go to another one. Remember USNB of San Diego, C. Arnholdt Smith?

Mr. HUERTAS. Yes.

Chairman ST GERMAIN. Did you study that one?

Mr. HUERTAS. No, I have not studied that in detail.

Chairman ST GERMAIN. Well, I would commend it to you, because here's a man who practiced a lot of fraud and deceit, two sets of books, two complete staffs. They wrote him up as being a workaholic, because he worked 16 hours a day. But you know what he was doing, don't you? He worked 8 hours with one staff and one set of books and 8 hours with another staff, with another set of books. [Laughter.]

Now you're telling me that the people who hold a subordinated debt would have caught that one? The examiners didn't catch it. All kinds of sophisticated people didn't catch it. The SEC was calling him on it, and yet the Comptroller's Office still couldn't find it. I commend that one to you, sir.

Mr. HUERTAS. I'm not suggesting that they would catch it. What I am suggesting is that the subordinated debt holder or the uninsured depositor would demand a premium on the rates to compensate him for the possibility that such fraud might occur.

Chairman St Germain. Oh, are they going to do that on every institution?

Mr. Huertas. On the institutions where they have a great degree of confidence that fraud would not occur, where they had——

Chairman St Germain. How did they reach that conclusion? Seon Holt Smith was a friend of Richard Milhaus Nixon. God, he got all kinds of awards in California for doing all these wonderful things. No one ever thought that that man had two sets of books, two staffs and two everything.

Now tell me how would that subordinated debt holder have caught that one?

Mr. Huertas. I'm suggesting that the subordinated debt holder would be perfect, nor am I——

Chairman St Germain. What I'm suggesting, sir, as Chalmers Wylie brought out, is that when it comes to fraud, boy, very few people are going to catch it. Amen. Mr. Roth.

Mr. Roth. I thank you, Mr. Chairman.

I want to give Mr. Lumpp a chance to answer that question too, I know in your statement to the committee here, you were not in favor, in fact, you were very adamant opposed to risk-related debt premiums. It seems that those people are causing the problems, the poor portfolios and poor management. I can't understand why this risk-related premium is not the route to take. And I would like to have you address that also.

Mr. Lumpp. It has to sound a little inconsistent for a person representing the property and casualty industry to make a comment against risk-related premium, when, in fact, it's the very basic approach that we use in insuring personal lines and commercial lines of insurance on a day-to-day basis.

I make the comment at this point in time to suggest that a quick move to a risk-related premium without establishing an understanding of how risks are going to be evaluated, what the premium differentials are going to be and what the likely subsequent impact of deposit insurance differentials will be on the attitude of the management of an institution that's suddenly paying a higher rate, for example, trying to more aggressively pursue a higher rate of return to cover the increment of cost.

But let me make another observation, which I think goes hand in hand with that. I believe that the overall rate that has been charged for deposit insurance, historically, has not been high enough, and perhaps a preferred move would be an escalation of the overall rate versus a differentiation which would keep the base rate as low as it is and perhaps raise the rate for a less preferred subset of the institutions, as has been suggested, I believe within the last week or so—it's been out for comment from Mr. Isaac—raising the rate on some subset of the institutions by a factor of three or four.

I think the base rate itself should perhaps be examined first, before a differentiation, but in any event, to not quickly move to a risk-related rate at this time.

Mr. Roth. I thank you for that, but the way I view this, you know, we always hear the question, "Well, who's going to determine the risk?" and so on. Isn't the FDIC doing that now? I mean, we're told on this committee that we have about 1,000 banks that are in trouble.

So they're really making a judgment on that already, aren't they?

Mr. LUMPP. I believe that does suggest that they are making a judgment. Today, at least, or thus far, at least, they have not elected to take that conclusion and to apply it to a rate differential on the deposits of the institutions that they deem to be in that 1,000 population.

Mr. ROTH. Mr. Lumpp, I appreciated your testimony, but you know, we have people from the banking industry before this committee, and naturally, they're going to make the strongest case for themselves. It's only human nature, I suppose. But in the eight considerations you gave us, the last one you talk about, a system where the depositor is purchasing insurance rather than the financial institutions acting as an intermediary before the depositor and the insurer. In other words, we sort of circumvent the banking institutions, relieve them of some of the onus.

It would seem to me that the banking industry should have more of the onus. We should just be going in the other direction. So it was hard to sort of dovetail that eighth point with the others.

Mr. LUMPP. If I might, I think the eighth point is perhaps offered as a potential future development, when and if some of the earlier points are, in fact, in place. I believe that an uninsured depositor might find interest in purchasing directly from an insurer, a private insurer, some kind of coverage for some subset of his investment that might otherwise be uninsured.

I must assure you I have not thought through what that product might look like and what kind of rate might be charged.

Mr. ROTH. Well, I can see some real problems with that.

Mr. LUMPP. In fact, in the market, sir, in the last couple of years, there has been some degree of demand for excess FSLIC and excess FDIC insurance. There has been some interest over the last couple of years in whether or not private insurers would offer an insurance product above the $100,000 limits.

Mr. ROTH. That's like having an accident and health policy. You know, you have a broken arm, and the insurance company says, no, we don't cover it, the first one covered it. So that group would say we don't cover it, FDIC covers. And FDIC's always going to cover. We've seen that already, what happens—what happens here in Congress.

Mr. LUMPP. I must concur. In fact, there has been very little such requests for excess FDIC and FSLIC, since the Continental situation.

Mr. ROTH. Thank you. I have only so much time, so I want to ask Mr. Huertas one quick question, and that is, I talked to a lot of the members on that side of the aisle and some of this side, and you talked about $100,000 seems an overestimate of that—in your testimony, talking about the $100,000 insurance?

Mr. HUERTAS. That's right.

Mr. ROTH. Most of the people here—I shouldn't say most, because I haven't talked to all of them, but many of them are for a $200,000 limit.

Mr. **Huertas**. Well, on the basis of a——

Chairman **St Germain**. For what?

Mr. **Roth**. For $200,000, Mr. Chairman, not the $100,000 limit.

Chairman **St Germain**. There were people on the committee?

Mr. **Roth**. On our committee, who are——

Chairman **St Germain**. Really? My gracious. I haven't heard about that. I've heard people say we should bring it down to 50.

Mr. **Roth**. They're all afraid to talk to you. [Laughter.]

But this is why I bring up the question. I mean, we have a lot of people on the floor of Congress. I talk about these issues on the floor, and they'd say, $100,000 isn't enough. We should have $200,000.

Mr. **Barnard**. I'm aghast that anybody would suggest that you can't talk to the chairman. [Laughter.]

Chairman **St Germain**. I don't know about you, but my average constituent makes $19,000 a year. Tops. Right?

Mr. **Roth**. Yes.

Chairman **St Germain**. I've got news for you. $200,000, they're not at all excited about $200,000 insurance.

Mr. **Roth**. Well, I'm sorry to differ with you. I think they are. That's why——

Chairman **St Germain**. Well, I mean, absolutely, you must have an affluent constituency.

Mr. **Roth**. I'm not talking about my constituencies, Mr. Chairman. I'm talking about the people on this committee——

Chairman **St Germain**. Oh.

Mr. **Roth**. That are interested in a $200,000 rather than a $100,000.

Chairman **St Germain**. Well, I'm going to authorize the staff to take a poll.

Mr. **Roth**. Thank you. OK. [Laughter.]

So what kind of consequence would that have?

Mr. **Huertas**. Well, the basis for that is a survey of consumer finances conducted by the Federal Reserve Board, which indicated that over 95 percent of American families had total assets, including the equity in their homes, investments in stocks and bonds, et cetera, that amounted to less than $100,000. And the average deposit, total deposits at all banks put together, was around $10,000 to $12,000, I believe. I'd have to check that latter figure for you. But the average American family simply does not have $100,000 in all banks put together, much less any one bank in particular. And if he did have that kind of money, he has the option to put the second $100,000 in a second bank.

Mr. **Roth**. Maybe not an ongoing time, but you know, you buy a home here in Virginia, why it costs you almost $200,000, if you buy a decent home, $150,000. So if you sell a home, where are you going to put your money? You're going to put it in the bank; right? You want to know it's secure.

There I think is—sure, nobody's going to have $200,000 in a revolving checking account, but at one point or other, people are going to have it for a short period of time, and they want to know that that money is secure. And I think that's where the issue comes in, and we should address ourselves to that.

Mr. **Huertas**. That, as you suggest, is a relatively short period of time that people have it, it's a relatively large proportion of their total assets, but if they are concerned, I would suggest it is not that great an inconvenience for them to split that into two parts and put it into two different banks and have complete insurance in that fashion.

Chairman **St Germain**. Chase and Manny Hanny. [Laughter.]

Mr. **Roth**. Well, I think we've——

Mr. **Huertas**. Perhaps Fleet National and Rhode Island Hospital Trust.

Mr. **Roth**. Well, I think we've got some serious problems in this area, and maybe what we have to do, Mr. Chairman, is pass some of the legislation we've put out on the floor, and maybe that will help solve some of the problems.

All right, sir. I thank you.

Chairman **St Germain**. Professor Benston, have you given any thought to deposit insurance reform?

Mr. **Benston**. Oh, quite a bit.

Chairman **St Germain**. Really? Why didn't you tell us about it in your paper? In your presentation? Now your presentation told us about this study.

Is it the University of Rochester you're at?

Mr. **Benston**. Yes; I am.

Chairman **St Germain**. Yes. Did the University or Rochester commission that study?

Mr. **Benston**. Commission? Universities don't commission studies that I know of.

Chairman **St Germain**. Well, who commissioned the study?

See, I don't know. Never having done a study, I don't know who commissions them. You did that study because of curiosity?

Mr. **Benston**. In part, yes. I was very curious.

Chairman **St Germain**. And then what was the other part?

Mr. **Benston**. The financial support for the study——

Chairman **St Germain**. Pardon?

Mr. **Benston**. That is, the cost of the data, gathering the data, was provided by Cates Consulting. They get the data from the Federal home loan bank.

Chairman **St Germain**. By whom?

Mr. **Benston**. Cates Consulting——

Chairman **St Germain**. Cates?

Mr. **Benston** [continuing]. Analysts. They didn't commission it. I got the data for the study from them. They get it from the Federal home loan bank reports.

The financial cost of the data and of running the data, and so forth, were borne by Lincoln Savings & Loan. They paid the financial costs of doing the study.

Chairman **St Germain**. Oh, Lincoln Saving & Loan?

Mr. **Benston**. That's right.

Chairman **St Germain**. Yes. Now you've got that one in the record. That's delightful. But I'm wondering why you didn't talk to us in your submission to the subcommittee about deposit insurance reform, which is the subject of the hearings.

Mr. **Benston**. Because I think this is very relevant to deposit insurance reform. The question of deposit insurance reform is—there are two ways of being concerned about the failures of savings and loans and banks, which is, after all, the reason for deposit insurance.

Chairman **St Germain**. But this addressed only the study you did. I didn't hear you say a thing about commercial banks.

Mr. **Benston**. At the moment, I haven't had the opportunity to say very much.

Chairman **St Germain**. All right.

Mr. **Benston**. If I may, I will be glad to explain.

Chairman **St Germain**. Does your paper discuss commercial banks?

Mr. **Benston**. Commercial banks? No.

Chairman **St Germain**. What I'm saying is, the testimony that we put in the record limited itself to the study you did for Lincoln Savings & Loan and the findings thereof.

Mr. **Benston**. It reflects the study I did on savings and loans failures; yes.

Chairman **St Germain**. Right. On behalf of the Lincoln Savings & Loan.

Mr. **Benston**. They financed—they paid the financial costs of the study.

Chairman **St Germain**. Right.

Mr. **Benston**. In that sense, it was on their behalf, in no other sense.

Chairman **St Germain**. All right, but that's the point. That's all we have from you in your written prepared testimony.

Mr. **Benston**. That's correct.

Chairman **St Germain**. Thank you.

Mr. **Benston**. Excuse me, sir. May I have an opportunity to respond to your question?

Chairman **St Germain**. Oh, I am going to come back to you and ask you about deposit insurance reform, once the second round comes.

Mr. **Benston**. Oh, no, because you asked me the question earlier, in what sense—why I thought this study was relevant to the questions of this committee that were raised this morning. That's what I tried to say in my opening remarks. I had understood and thought it would be preferable not to read the printed statement, because you could read that and will read that, but to relate that statement to the issues.

Now I would have put that in the statement—I wrote this, frankly, this weekend, and didn't have the opportunity to do the full job. The data came to me in ways such that I had to be very careful the data were correct, and it took longer than I had anticipated.

Chairman **St Germain**. Well, we'll discuss the data on my next round of questions as well.

Mr. **Benston**. Surely.

Chairman **St Germain**. Mr. Bartlett.

Mr. **Bartlett**. Thank you, Mr. Chairman.

Let me begin with you, Professor Benston.

First of all, I would just say to the entire panel that I found the testimony that you have given to be excellent and quite well prepared. Obviously with the time that has been taken both by the chairman of this committee and also the full committee and also the time that each of you and your organizations have taken, illustrates that the problem of the insurance funds begins to take on some increased urgency. I am going to get back to that in a minute and ask each one of you to comment on that urgency.

That was a way of giving you a chance to think about it a little bit.

Professor Benston, I have a couple of questions to clarify some of the specific items of your testimony.

First, you testified, Professor Benston, that in your judgment direct investments per se were not a cause statistically of increased failure. I wonder if you attempted to find any correlation between those loans or investments in which the savings and loans were putting up 100 percent of the money without any equity required and whether that had a statistical relation to failure, or whether you examined that, whether net worth as it relates to growth; that is, net worth as a percentage of new growth or new investment, has a relationship to failure, whether geography has a relationship to failure?

I suppose I am looking just statistically at the high rate of failures from Texas, California, and Florida, and I happen to know that there is nothing wrong with those States that would cause a lot of failures.

And so my question is: Why would that statistical aberration be there or what other factors did you find related to failures other than cost of funds being higner than income, which seems to me to be rather obvious?

Mr. BENSTON. Taking it, if I can recall, in the order that you raise the questions, there is a very meaningful and useful distinction that should be made between a direct investment, which is an ownership of an equity or the actual property in which the S&L invests, and a loan which has very little equity in it by the borrower but nevertheless is a loan.

The distinction is essentially in the loan characterization, the loan situation. Even though there is very little equity by the borrower in it, the property is owned by the borrower and the monitoring of that property is done by the borrower.

Now, those loans apparently are associated with the failure of a number of associations. I say apparently because unfortunately the Federal Home Loan Bank Board has not seen fit to ask for a reporting of such loans on the reports that they ask the S&L's to render.

Mr. BARTLETT. Could I stop you at that point?

And therefore, you would recommend that they do examine that?

Mr. BENSTON. Oh, yes, and I think a very good case could be made, and should have been made, not for a regulation that said the S&L's are limited in the amount of direct investments they can have but that they are limited in making loans with very low amounts of equity, or that specifies minimum equity amount for loan. I think there is a good case, very good case, that could be made for that, although I wish there were data available and studies were done to indicate the extent to which that is a problem.

I couldn't do such a study because the data aren't available. I wish I could have, and I would have done a study if I could.

The second thing—now, I am trying to recall the question.

Mr. **Bartlett**. So you would urge a minimum equity requirement?

Mr. **Benston**. I think there is a very good case that could be made for it, but I don't know of any research on it, none that I have done and none that I have known anyone else has done.

Mr. **Bartlett**. And then net worth as it relates to high rates of growth?

Mr. **Benston**. Now, the net worth—obviously, negative net worth is related to failure. In fact, it is almost a definition of failure. In terms of rates of growth, there have been a number of S&L's that have grown very considerably and have failed apparently as a consequence, and I have to say the data show a lot of them have grown very considerably and have not failed and have done quite well.

I think a very good case can be made for the home loan bank's regulation that says that if you are going to grow you have to have the equity to back that growth. I don't think it a good case—the data do not make a good case for that aspect of the regulation which says you have to have proportionately more equity if you grow proportionately faster.

That is to say, if you grow at the rate of, say, under 10 or 15 percent you have to have 3 percent and if you grow at the rate of—I can't remember the exact numbers in the regulation—10 to 15 percent you have got to have 4 percent, and at a rate of 25 percent rather—over 25 percent—you have to have 5 percent additional equity on that additional growth.

The data does not support that kind of an increasing percentage. As far as I can see, the data do support that growth should be accompanied with equity, that the growth simply should not be on the back of the FSLIC, effectively.

Mr. **Bartlett**. And geography?

Mr. **Benston**. Well, in doing the study I attempted to hold geography constant by comparing S&L's that haven't failed in Texas, California, Florida, New York, Michigan, et cetera, with those that had failed in the same regions. Therefore, I can't speak to the question of geography, because I tried to hold that constant for fear that I would find that there were more failures, say, in Texas or California, which I already knew, and yet their failures were related not to individual aspects of the S&L's, but to the fact that maybe their regions have problems or that something else was going on that I didn't know about.

So I didn't study geography as such. I held it constant in the study, so I can't speak to that question.

Mr. **Bartlett**. So you made no effort to determine why there would be a higher rate of failure for California, Texas, or Florida than another State?

Mr. **Benston**. That is right; yes.

What I was concerned about is were the State laws in, say, Texas and California and Florida that allowed S&L's to invest in direct investments responsible for the failures in those States or was there something else, and I found that it was not those laws that were responsible for failure.

Mr. **Bartlett**. Mr. Huertas, I have two questions that are technical questions as to your testimony. First, you advocated the use of subordinated debt.

Are you advocating that as a part of the FDIC proposed 9-percent capital requirement, as the FDIC has proposed the use of subordinated debt, but only in conjunction with the higher capital requirement, or are you saying that even without a higher capital requirement you would advocate subordinated debt to be part of the capital?

Mr. **Huertas**. We have taken the position with respect to the FDIC proposal as it stands, and we would accept that proposal.

I would emphasize, as Dr. Eisenbeis had before me, that the subordinated debt under that proposal is an option to fulfill that requirement.

I think one could also give consideration to allowing banks to use subordinated debt to fulfill capital requirements without any increase in the total capital requirement, but since that was not a proposal on the table we did not take a specific position.

Mr. **Bartlett**. Thank you.

Mr. Chairman, my time has expired, but if I might ask one additional question of a general nature? It will be a brief question, and I would hope for a brief answer.

Could you each describe where you would place the urgency of acting, whether it is congressional or regulatory, to preserve the safety and soundness of the FDIC and the FSLIC?

Professor Benston, how would you describe the urgency?

Mr. **Benston**. Well, I would say that it is pretty urgent but not desperately urgent, in the sense that a lot of the problems have already happened, and the urgency basically is to reform the system so that it doesn't get worse and that we don't have further problems.

Mr. **Bartlett**. Mr. Eisenbeis?

Mr. **Eisenbeis**. I would generally agree, although I think that the potential problems are greater right now in the thrift industry than in the commercial banking side.

Mr. **Bartlett**. Do either of you have a time line to measure what you mean by urgent but not desperate? Does that mean that we have 2 years to act or 6 months or 10 years?

Mr. **Eisenbeis**. I think as far as the thrift industry is concerned you have probably got somewhere between 1 year to 2 years.

Mr. **Benston**. I would agree with that. I think that the thrift industry has problems because there are many—not an enormous number, but many insolvent institutions that have great temptations to take risks. It can be much worse on the one side.

And then the second side, if they are forced back into the mold of making mortgages and specializing in savings, then we are just laying ourselves wide open for exactly what happened and no deposit insurance scheme will be able to protect us.

Mr. **Bartlett**. Mr. Huertas?

Mr. **Huertas**. I think the urgency depends upon what you would decide to do. I think, as I outlined, the modified payoff and subordinated debt is the optimal solution to the problem. We feel that it should be adopted quickly.

Doing nothing would be a second best solution, and some of the other proposals, specifically risk-related deposit insurance premiums, would be positively harmful, and obviously there is no urgency to take a step that would be harmful.

Mr. LUMPP. The issue of solvency is very much on the minds of the regulators of the insurance industry right now, and to the extent that the public at large is concerned about the solvency of the Federal funds it is also quite probably looking at the way in which those mechanisms are going to be refined, and I think we have maybe a unique and an additional sense of urgency not only about the timing but, as Mr. Huertas has mentioned, the nature of the kinds of actions that are taken.

As I said in my testimony earlier, I would be concerned about fixing something that isn't broken, but I would also be concerned about moving too quickly. I think what we do as well as when we do it is important for us to take into consideration.

But again my industry is suffering, and it is another insurance industry, if you will. It is another set of insurance companies. The regulators thereof are very concerned about solvency, and there are just an awful lot of parallels.

And so, I have that additional sense of concern, certainly for my company and I think for my industry at large. We have a very large insurance company, in effect, with the FSLIC and the FDIC, and how it makes it way through this next couple of years will be providing some examples to the citizenry as to their expectations for some of the private insurance companies that will be trying to come through this period, also.

Mr. BARTLETT. If you would answer your own question? Is it broke? The FSLIC and the FDIC, are they broke or are they breaking or are they in the not broke category?

Mr. LUMPP. I don't believe that many of the aspects of the FSLIC mechanism and the FDIC mechanism are broke. I believe that there has been some cumulative effect of a high inflation decade, fast growth in certain parts of the country that has caused people to try to manage problems of orders of magnitude that they have never been asked to manage before, and it has caused some additional and current pressures on those insuring mechanisms.

I don't think the mechanisms themselves are necessarily broke.

Mr. BARTLETT. Thank you.

Thank you, Mr. Chairman.

Chairman ST GERMAIN. Professor Benston, does your study include loans that were actually equity investments, such as those in the Empire situation?

Mr. BENSTON. The loans in the Empire situation were not actually equity investments.

Chairman ST GERMAIN. Well, that is an interpretation by Professor Benston. There are others who look upon them, such as—let me quote:

"Empire had used its brokered funds for ADC loans concentrated on the I-30 corridor near Dallas. The loans were in economic fact direct investments. Many involved fraud. Reappraisals indicated massive losses."

You know what happened at Empire, don't you?

Mr. BENSTON. I believe so.

Chairman **St Germain**. Where within 1 day they flipped over titles and then the next day they flipped those same titles over again and every time they flipped them over the price increased and increased and increased?

Mr. **Benston**. Yes, I——

Chairman **St Germain**. You studied that thoroughly?

Mr. **Benston**. Yes, I did. Well, I studied it.

Chairman **St Germain**. I had a very thorough briefing by the Federal Home Loan Bank Board on that one, and as a matter of fact, I viewed the area as well. I guess honest people can have honest differences of opinion on whether or not those were direct investments.

Now, in the case of San Marino, do you feel that there were direct investments there?

Mr. **Benston**. May I ask you, sir, with respect to Empire, since you studied it, did the Empire Savings & Loan have title to the properties on which it was making its——

Chairman **St Germain**. It is the manner in which the investment is structured—it is not the title.

Mr. **Benston**. No, I think——

Chairman **St. Germain**. You can have a direct investment without having title.

Mr. **Benston**. I would have expected that there is a meaning in terms of whether something is owned or it isn't owned in terms of what it is. It may be that a loan is a terrible loan. It may be that a loan is a fraudulent loan. That does not make it a direct investment.

Chairman **St Germain**. If I am a member of a limited partnership, is that not a direct investment that I make when I purchase my share in the limited partnership?

Mr. **Benston**. To the extent of your share, you have an investment.

Chairman **St Germain**. Correct.

Mr. **Benston**. But it is not a direct investment——

Chairman **St Germain**. You don't feel as though it is?

Mr. **Benston**. It depends upon the amount of the share. If you have a 1-percent share, it is not a direct investment. If you have a 51-percent share, it is a direct investment.

Chairman **St Germain**. In the case of Empire, there are experts who feel that the loans were direct investments.

Now, how about the case of San Marino?

Mr. **Benston**. I haven't studied that sufficiently well to be able to say.

Chairman **St Germain**. Well, one of the dilemmas there was again whether or not it was a direct investment. You have read where that was the big controversy in the San Marino situation?

Mr. **Benston**. Are we talking about Beverly Hills or San Marino?

Chairman **St Germain**. I am sorry, Beverly Hills.

Mr. **Benston**. OK, that I have studied, and in Beverly Hills there is a great contention, and we have public accountants who—I read the testimony on that—who claimed—and remember, I can only go on what they have said. I wasn't there—that using generally accepted accounting principles and the guidelines of the AICPA, that they felt that their classification of the loans was such that they were loans and not direct investments.

Chairman **St Germain**. OK, let's get back to San Marino now. You don't feel as though the bad acquisition, development, construction, ADC, and loans there in San Marino were direct investments.

Mr. **Benston**. An acquisition, development and construction loan is just what it says. It is a loan. Now, it may be a loan on property that is risky. It may be a loan that was not made with adequate security. It may be a loan that was made with a bad appraisal, but it is nevertheless a loan.

The Federal home loan bank's regulations do not talk about whether something is a loan or not. They talk about a direct investment. If they wished to make a distinction between property that is in fact owned and equity that was in fact owned, and loans that they thought had very low equity by the borrower, they should have made that distinction rather than simply eliding the terms and acting as if something is one thing simply because they say it is.

That is not only, I would think, very poor legal construction of a regulation but very poor thinking.

Chairman **St Germain**. OK. Now, Professor Benston, the data package No. 2 on failed institutions, S&L's, comes up with a number of 519. The testimony that was given before this subcommittee was—and this is from 1980 through January of 1985—that there were 484 failed S&L's.

You studied 202 of them?

Mr. **Benston**. 202, the exact number that the FSLIC has said have failed.

Chairman **St Germain**. Well, obviously, here again we have a definitional difference because when they testified before us on September 11 they gave us a total of 484 for those years 1980 through January of 1985.

Mr. **Benston**. I have asked them for the list, and they won't give it to me.

Chairman **St Germain**. Well, let me see if we can get it for you.

Mr. **Benston**. I appreciate that.

Chairman **St Germain**. Because I think that perhaps that would be helpful in your study.

Mr. Huertas, you heard Professor Eisenbeis comment on the strategy of using holding company affiliates and subsidiaries to perform activities that are a little different from that which the bank itself is allowed to perform, and he used a word that I thought was very direct when he said it was "naive."

Am I correct? I think I wrote that down properly. It is "naive" to think that you can separate the two?

Chairman **St Germain**. Now, I know that Mr. Angermueler, my dear friend, feels that they can be separated. I assume that since you are the assistant to that vice chairman, that you probably agree with him.

Mr. **Huertas**. That's a safe assumption.

Chairman **St Germain**. OK. Now would you care to expostulate on this?

Mr. HUERTAS. Well, I think we have here a clear instance of difference of opinion. I think the major concern should be about differentiating the risk of the instrument. We're talking about the risk of a deposit, not the risk of a bank. And that is the relevant concern for the question of deposit insurance reform.

And, obviously, the risk of a deposit is very different from the risk of subordinated debt or the risk of the stock or the equity in the bank, although all of them do depend upon the performance of the bank or the institution.

The relevant concern, in our opinion, is to look at the risk of the instrument and to look to see how that risk can or should be reduced, and what regulations, if any, should be placed on the institution to achieve the desired reduction.

Chairman ST GERMAIN. Define "institution" now, if you will.

Mr. HUERTAS. The institution would be the bank itself and there may be risks from the holding company or from other affiliates in the holding company that could affect the risk of instruments issued by the bank.

But I would submit that there are protections that can be put in place that would serve to protect the holders of deposits or other instruments issued by the bank itself.

And I guess as counterveilling evidence I would cite the relevant finance theory literature, and we could debate long and hard and using both hands, as economists want to do, and try to decide who is naive or whether we're both naive.

But I think we would go most of the day on that. But I would submit that there is indeed another point of view. We feel there are strong reasons for that point of view. And we can go forward from here.

Chairman ST GERMAIN. What happened in Continental Illinois then?

Mr. HUERTAS. I think, in the case of Continental Illinois, it was a policy decision.

Chairman ST GERMAIN. Did the regulators do something nasty? Did they mess up? Were they misguided? Were they naive? Because they did lump it all together; didn't they?

Mr. HUERTAS. It is our opinion that that is not proper policy.

Chairman ST GERMAIN. Oh, that was not his intention. No. No. That's what everybody, all the financial press, many of whom are not here any longer this afternoon because they've gone to lunch, but they all wrote the story up as saying: Bill Isaac said everybody would be fully insured.

But then he came before this committee and said, "That's not what I said. I said they wouldn't lose any money." [Laughter.]

Mr. HUERTAS. Well, again, our intent is not to rewrite what should have been done in the case of Continental. Our intent is to advocate policies that would prevent the type of bailouts that have occurred in the past. We believe this will create a sounder and more stable financial banking system in the future.

Chairman ST GERMAIN. One of our very erudite staff people here brings me the regulation of direct investment in equity securities, real estate, service corporations, and operating subsidiaries. And that's—any interest or instrument commonly known as an equity security.

It says: All loans having profit-sharing features which would be reclassified as equity investments on the generally accepted accounting principles or the corporation's accounting regulations are applicable; or any security meaning the convertible at the option of the holdup, and so forth.

This is from the annotative manual, section 1154(E), subparagraph 563.9-8, "Regulations of Direct Investment in Equities."

That's the insurance regulations of the Federal Home Loan Bank Board, Professor Benston. Had you looked at that definition?

Mr. **Benston**. Would you please tell me the effective date of that regulation? Your staff member, no doubt, knows that.

Chairman **St Germain**. That was March of 1985.

Mr. **Benston**. March of 1985, that's correct. And prior to March of 1985, that was not the regulation.

Chairman **St Germain**. At this point, however, this regulation is in place.

Mr. **Benston**. And Empire did not fail after March 1985.

Chairman **St Germain**. Oh, no, it failed previous to that.

Mr. **Benston**. That's right, and that regulation, therefore, is irrelevant.

Chairman **St Germain**. I just have to depend on my very erudite staff here.

Mr. **Benston**. I'd just like to help them out.

[Pause.]

Chairman **St Germain**. Oh, the staff tells me that the regulations simply codifies what the law is.

Mr. **Benston**. The regulation codifies what the FSLIC later decided the law ought to have been.

Chairman **St Germain**. Oh. [Laughter.]

Mr. **Wylie**. Mr. Chairman?

Chairman **St Germain**. Yes, sir. Mr. Wylie.

Mr. **Wylie**. We have a vote on and I would just like to take this opportunity to congratulate the panel. I think that is a very knowledgeable and bright panel and certainly have made a very meaningful contribution to our deliberations today.

Thank you, sir.

Chairman **St Germain**. Professor Eisenbeis, I'm going to give you a couple of minutes to respond to the distinguished gentleman, Mr. Huertas, about the holding company affiliates and subsidiaries and his answer to my quote.

That was a quote. I was quoting you.

Mr. **Eisenbeis**. Right. He correctly indicated that this was a point of difference between us. And I think that we have a situation where I'm looking at it from the perspective of the insuring agency and the interest that they have in protecting their risk exposure.

And I'm concerned about putting in place a structure that implies increased regulatory burdens in order to try to keep things separate, when, in fact, when push comes to shove and institutions get in trouble, they will be highly motivated to draw on the resources of the entire entity to rescue a troubled subsidiary. And I know that this has happened in many instances. One clear one is Hamilton Bankshares, where there was a clear impact on the bank from some of the mortgage banking activities that the subsidiary engaged in. There were 23A kinds of restrictions that said: Thou shalt not pass assets through.

But when they got into trouble, they did it. So the fact that you have regulations in place doesn't mean that it won't happen. I would rather see the situation where you decide what activities an entity can engage in, let the bank engage in those activities. I would rather see a simplification and have us get rid of the holding company structure.

In other words, I would rather see us put all our eggs in one basket and then let the insuring agency watch the basket; rather than trying to incur and impose a lot of costs to keep things separate and, in the meantime, take away all the benefits of engaging in that activity.

I'm for simplicity in this particular case.

[Pause.]

Chairman St Germain. I've got to tell you. Maybe you were aware of this, Professor Eisenbeis. I don't know about Mr. Huertas but there used to be a chap that came up to testify, a very, very brilliant gentleman. He used to of course, give his testimony. It ran 2 hours, so he wouldn't leave much room for questioning because he would puff on his pipe in between pages. But he was brilliant. A guy named Arthur Burns.

He had quite a technique. By the time he finished testifying, the press had all gone to lunch.

But when I asked him about the holding company—God, this is when he was still in office. And, since then, of course, we have had Bill Miller. And then we have had Paul Volcker.

But he, in answer to a question of mine way back then, stated that, in truth, he had to admit that they didn't have the capacity to properly examine and regulate the holding company affiliates. The situation has exacerbated since then with the reduced number of personnel.

Do you recall that, Professor Eisenbeis, when he made that statement?

Mr. Eisenbeis. Yes, I do. I think that——

Chairman St Germain. The press did eventually report that one.

Mr. Eisenbeis. That's a problem. You alluded to the fact that it was hard to maintain staff and that there was a lot of turnover. Part of it is the fact that they don't pay competitive wages. And no one says that this job is simple, and no one says that it's cheap. It's a difficult task, certainly.

On the other hand, I hate to get into a situation where the ability of institutions in the marketplace to function is somehow held captive to the bureaucratic inflexibility and incapabilities of the institution.

If they don't have the capabilities to do the job, then let's find somebody who does.

Chairman St Germain. Well, you see, that's one of the many dilemmas we have. That's why we're having these hearings on deposit insurance reform, because on the one hand, institutions contend that they need more flexibility, but, on the other hand, we're not able to properly examine those institutions now.

Penn Square, you know, the Comptroller's Office never communicated. The Dallas office never communicated with the Chicago office.

Mr. **Eisenbeis.** Yes.

Chairman **St Germain.** Had they done that, much of the problems, maybe even Continental Illinois' problems would not have been of the magnitude that they were. So, on the one hand, they want more flexibility. But, on the other hand, they don't have the personnel.

Now, if they want insurance, you know, somebody said, Well, the private insurance companies will do it. But Mr. Lumpp tells us this is not the time.

Mr. **Eisenbeis.** Right. Well, I want to make——

Chairman **St Germain.** Somebody mentioned catch 22 before. I think we're on a catch two million, two hundred, two, two, two, two, two.

Mr. **Eisenbeis.** I know that you have spent a lot of time chastizing the regulatory agencies for their failures in not following up in these activities, and I commend you for that. And I hope you keep it up because that's the kind of pressure that we need to ensure that proper procedures are followed.

But I guess I hate to see that kind of a problem hold an industry back either. I know Professor Benston has studied that problem quite in detail. You may want to ask him about it.

Chairman **St Germain.** Professor Benston, we're running short of time, we've got to vote.

But would you please submit to us in writing your suggestions on deposit insurance reform, but particularly address the issues of personnel shortages, and the training, or lack of training, for personnel; and then, on the other hand, the necessity for increased diversification.

Mr. **Benston.** Very briefly, we did study this in the study that Bob Eisenbeis and I participated in. I wrote those chapters of the study. Essentially, one form of risk-based premium that would partially solve this problem is charge the banks and savings and loan associations a per diem charge that is sufficient to pay the cost to the agencies of doing those examinations.

That way, the more risky the association or bank is, the more its fee effectively and, yet, that will compensate the agencies and permit them to hire the personnel who can actually do those examinations and conduct the supervision that's necessary.

I think most of us would be very much in favor of the regulators looking closely at the bad actors in the industry. There are certainly some.

Chairman **St Germain.** Yes, we all agree on that.

Mr. **Benston.** Our concern really is that the whole industry should not be held down by the fact that there are some bad guys out there who have to be held down.

Chairman **St Germain.** Mr. Lumpp, if you hear of an insurance company that disagrees with you and wants to take on a coinsurance or alternative insurance, please let us know immediately, will you?

Mr. **Lumpp.** Mr. Chairman, I most assuredly will. I would also point out that the concept that was just discussed to pay for the examination process is a concept that has been in place for many, many years when insurance companies are examined by their respective insurance departments.

We are assessed in a fashion much like was just described.

Chairman ST GERMAIN. Right. I'd like to continue but, as I say, there are constraints with time. Very, very sincerely, our deep, deep gratitude to each and every one of you for helping us out this morning. We will be submitting some written questions to you for further amplification.

When you review the transcript, if you have some other points you'd like to make, please feel free to do so. But indicate those to us separately so that our highly efficient staff—really and truly, I've got a super staff—will bring those to the attention of the members.

The subcommittee is in recess until tomorrow morning.

Mr. EISENBEIS. Thank you.

[Whereupon, at 1 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Thursday, October 3, 1985.]

[Letters of invitation to witnesses for this day of hearing; and written questions submitted to Professor Bentson, with attached responses, follow:]

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STEVE BARTLETT, TEXAS
TOBY ROTH, WISCONSIN

September 10, 1985

Dr. George Benston
Professor of Accounting
University of Rochester
Rochester, NY 14627

Dear Dr. Benston:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on October 2, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

1. Modified Payoff
2. Subordinated Debt Capital
3. Risk-related Deposit Insurance Premiums
4. Risk-related Capital Requirements
5. Insurance Fund Recapitalization
6. Insurance Fund Merger
7. 100% Deposit Insurance Coverage
8. Reduced Deposit Insurance Coverage
9. Greatly Instensified Supervision
10. Market Value Accounting
11. Private Deposit Insurance
12. Brokered Deposit Restrictions

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building twenty-four hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing record, and if delivered when requested, the statement will be made available to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv

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TOBY ROTH, WISCONSIN

September 10, 1985

Dr. Robert Eisenbeis
Professor of Banking
University of North Carolina at Chapel Hill
Chapel Hill, NC 27514

Dear Dr. Eisenbeis:

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Fernand J. St Germain
Chairman

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TOBY ROTH, WISCONSIN

September 10, 1985

Mr. Thomas Huertas
Assistant to Vice Chairman
Citibank, N.A.
399 Park Avenue
New York, NY 10043

Dear Mr. Huertas:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on October 2, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

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Sincerely,

Fernand J. St Germain
Chairman

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WASHINGTON, DC 20515

[illegible]

September 10, 1985

Mr. Roger Lumpp, Vice President
CNA Insurance Companies
CNA Plaza - 205
Chicago, Illinois 60685

Dear Mr. Lumpp:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on October 2, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

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Chairman

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WASHINGTON, DC 20515

October 18, 1985

Professor George J. Benston
Professor of Accounting Economics and Finance
Graduate School of Management
University of Rochester
Rochester, N.Y. 14627

Dear Professor Benston:

Pursuant to your testimony before the Subcommittee on Financial Institutions on October 2, 1985, attached you will find additional written questions, the responses to which will be included in the hearing record. In order that we may complete this record in a timely fashion, we would appreciate a response by November 6, 1985.

Thank you for your cooperation and for the presentation of your most interesting testimony.

Sincerely,

Fernand St Germain

Fernand J. St Germain
Chairman

FJStG:kTk

ADDITONAL QUESTIONS FOR PROFESSOR BENSTON

1. In your testimony before the Banking Committee, you stated that "the loans involved in the Empire situation were not actually equity investments" based upon the fact that legal title was not transferred to Empire. When you studied the Empire failure, where you aware of a Notice to Practioneers issued by the American Institution of Certified Public Accountants in November, 1983, advising practioneers that direct investments in real estate activities were being misclassified as loans, and that nine factors, other than transfer of title, should be considered when classifying these assets?

2. In October of 1984 the Federal Home Loan Bank Board issued a proposed statement of policy which essentially incorporated the criteria set out in the AICPA notice referred to above (49 Fed. Reg. 43557). This policy was formally adopted on April 30, 1985 (50 Fed. Reg. 18233). At that time the Bank Board explained " The proposed policy statement was intended to put into regulatory format the accounting guidfance that had been developed by the accounting profession and to state that there was no substnative difference between the Board's regulatory treatment and GAAP with regard to these transactions: if an ADC transaction is deemed to be a loan in accordance with GAAP, it would be classified in the same manner for regulatory purposes." Is your determination that a loan is not an direct equity investment if legal title does not change in accord with GAAP either at the time of your study of the Empire failure or at the time of your testimony before the Committee?

3. In your testimony before the Committee you assert that direct equity investments have not been a major cause in the failure of the thrift institutions you have studied. As an accounting and financial expert, shouldn't your conclusions on this subject be based on the economic reality of the underlying transaction, i.e. whether in an economic sense the transaction was a loan or an equity investment, and not how the transaction is classified for legal purposes?

4. As a legal matter, the courts and regulatory agencies are often directed to disregard the form of a transaction in order to determine the underlying substance of that transaction. For example, in *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967), the Supreme Court stated "in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the empahsis should be on economic reality." Other examples of disregarding form and looking at the economic reality of a transaction abound. See, e.g. *First National Bank of Plant City* v. *Dickinson*, 369 U.S. 122 (1969); *American Timber & Trading* v. *First National Bank of Oregon*, 690 F.2d 781 (9th Cir. 1982). Based on this legal principle, shouldn't certain loan transaction be classified as direct equity investments regardless of the existence of explicit Bank Board regulations requiring such classification?

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November 5, 1985

RECEIVED
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Subcommittee on Financial [illegible]

Honorable Fernand J. St. Germain
Chairman
U.S. House of Representatives
Subcommitte on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking,
Finance and Urban Affairs
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to respond to the four written questions that you sent to me on October 18, 1985.

1. Question: "In your testimony before the Banking Committee, you stated that the loans involved in the Empire situation were not actually equity investments based upon the fact that legal title was not transferred to Empire. When you studied the Empire failure, where [sic] you aware of a Notice to Practioneers [sic] issued by the American Institution [sic] of Certified Public Accountants in November, 1983, advising practioneers [sic] that direct investments in real estate activities were being misclassified as loans, and that nine factors, other than transfer of title, should be considered when classifying these assets?"

   Response: I was aware of the AICPA "Notice to Practitioners," and I presume that the public accountants who audited Empire and the Federal Home Loan Bank Board's examiners, supervisors, and board members who reviewed Empire's records also were aware of it. Consequently, it seemed reasonable for me to accept the financial reports filed by Empire and officially released by the FHLBB as being correct. In their official reports the Bank Board specified two and only two categories of direct investments: "real estate investments held for development/investment/resale" and "service corporations/subsidiaries: equity investment." It was on these categories, defined by the Bank Board, and the corresponding numbers released by the Bank Board that I relied in my studies.

After reviewing the Hearing April 25, 1984 on Empire*, and the public statements of the FHLBB about which I am aware, I must accept their statements that the numbers reported under those categories are the totality of Empire's direct investments (except for equity securities that were not and still are not separately reported). The testimony given at the Hearings and the documents printed in the report show the following:

1. The FHLBB's January 6, 1984 Notice of Charges and Hearing that preceded the closing of Empire identifies the association's problems as stemming from bad "loans." It states:

> "Empire S&LA's assets consist primarily of loans secured by speculative condominium projects and land for similar projects. ... Certain of these loans are subject to the unsafe and unsound practices described above, i.e., lack of records, lack of appraisals or deficient appraisals, and excessive loans to one borrower. ... [b]orrowers on these loans have little or no equity in these land purchases or condominium construction projects."

(p. 389 — all references are to the April 25, 1985 Hearing; emphasis added.)

2. The FHLBB press release on Empire's closing (dated March 14, 1984) explains the causes of the failure as follows:

> "The findings of a recent examination indicate that the association engaged in questionable lending practices, including the financing of speculative land loans and condominium construction projects. Real estate appraisals, artificially inflated by multiple land sales among a group of associated individuals, provided the basis for the questionable loans, which greatly exceeded the value of the underlying real estate security. In many cases, the excess of the loan amount over the real value of the property was used to cover all loan fees and closing costs and to pay an incentive bonus to borrowers just for signing the loan papers. Often these borrowers were not required to make a down payment or contribute any of their own funds." (p. 185)

Except for a prior statement about brokered deposits, this is the entire explanation for the failure given in the release.

3. Empire's former Chairman and principal stockholder, Spencer Blain, Jr., in describing his discussions with Texas Savings and Loan Commissioner Linton Bowman III, said:

> "one of the things that has been discussed is whether the loans that we made constituted investments or not. Almost all of the loans that we made involving land were already made at the time the accountants got into that fight. The accountants got in that fight among themselves, and I would say to Bowman or to anyone else, we

have got loan documents, we think they're loans, the people owe us the money, they think they're loans." (p. 169)

4. The latest *Report of Examination* reproduced in the Hearings does *not* reclassify these loans as direct investments for August 31, 1983 or for previous periods. The narrative portions of the *Reports of Examination* refer to "loans" rather than to direct investments, and mention is made of any alleged misclassification of these assets. Thus, the Bank Board repeatedly stated that Empire's investments were "loans." Even more convincing, the Board did not have Empire's records changed. Had the examiners and supervisors believed that these loans were direct investments, they could have ordered a change or shown the numbers as direct investments in the FHLBB reports. As FHLBB General Counsel Norman Raiden testified:

> "If our examiners find that there is improper accounting, then we can require that the accounting be corrected, and if it's not, if the practice could lead to a substantial dissipation of assets, then we can issue an immediate cease-and-desist order." (p. 139)

Accordingly, I relied on the Bank Board's own classification decisions. If these figures are inaccurate, it is incumbent on the Bank Board to explain why, to correct them, and to provide the public with the opportunity to examine the Board's analysis and the "correct" figures.

Confusion seems to have grown up after FHLBB Chairman Gray testified at the hearing. In his prepared testimony he stated that Empire's "explosive ... growth was fueled in large part by brokered deposits and was invested to finance what we believe to have been fraudulent real estate transactions and speculative construction in massive amounts." (p. 80) Further, he stated that Empire made "interim construction loans [which] ... were found to equal 47.8 percent of its total mortgage loan portfolio. In 16 out of 34 construction loan projects reviewed by the examiners the borrowers had little or no funds invested in the projects." (pp. 84-85)

Nevertheless, although Mr. Gray stated that Empire used apparently "fraudulent" transactions and made apparently risky loans, he then proceeded to lump all of these together as "direct investments." His testimony suggests that he did so in a roundabout attempt to focus on a significant, but relatively simple and obvious accounting problem. He pointed out that, if the "risky" loans were treated as direct investments "for acounting purposes, Empire's recorded income for this period would have to be substantially reduced." (p. 88) Mr. Gray explains this result by noting that in booking "loans" rather than "direct investments,"

> "Empire could speculate in real estate development while increasing its paper assets with artifically and fraudulently inflated loans and increasing its paper net worth with income from loan fees, interest, and closing costs that Empire itself was, in reality, paying." (p. 89)

Thus, Mr. Gray's point was that Empire, by following a regulatory accounting practice (RAP) that the FHLBB allows for loans (a practice not permitted for loans by generally accepted accounting principles, GAAP, and not permitted by RAP or GAAP for direct investments), was able to meet the FHLBB's formal net worth requirements and to mislead the Bank Board's supervisors with its overbooked loan fee income (achieving the latter result in spite of the fact that the FHLBB's examiners knew about this overbooking practice and criticized the loans repeatedly).

This background clarifies both the roots of the "loan-direct investments" confusion and the fatal flaw in the Bank Board's position. The apparent fact is -- as both Mr. Gray and the House Committee agreed — that Empire failed due to alleged massive fraud, extremely risky and questionable loans, and accounting manipulations. The Bank Board's supervisors failed to stop the manipulation even though they knew it was taking place. And now, for whatever reason, the Bank Board refuses to change its regulatory accounting principles (RAP) or to admit -- as the House Committee on Government Operations expressly found — that it had failed to exercise its available powers to supervise Empire and that Empire got into trouble in the old fashioned way, by making poor and allegedly fraudulent loans. Instead, the FHLBB seeks to place the blame on a relatively new — and, as I have shown elsewhere (see February 27-28 Hearing**), a profitable and desirable — development, direct investments. This is bad economics, bad accounting, and bad regulatory practice.

In my response to the next question, I explain why direct investments should be considered as being different assets than loans with low or no borrowers' equity.

2. Question: "In October of 1984 the Federal Home Loan Bank Board issued a proposed statement of policy which essentially incorporated the criteria set out in the AICPA notice referred to above (49 Fed. Reg. 43557). This policy was formally adopted on April 30, 1985 (50 Fed. Reg. 18233). At that time the Bank Board explained 'The proposed policy statement was intended to put into regulatory format the accounting guidfance [sic] that had been developed by the accounting profession and to state that there was no substnative [sic] difference between the Board's regulatory treatment and GAAP with regard to these transactions: if an ADC transaction is deemed to be a loan in accordance with GAAP, it would be classified in the same manner for regulatory purposes.' Is your determination that a loan is not an direct equity investment if legal title does not change in accord with GAAP either at the time of your study of the Empire failure or at the time of your testimony before the Committee?"

Response: As Abraham Lincoln said, calling a dog's tail a leg does not make a dog a five-legged animal. Similarly, calling a loan a direct investment does not make it a direct investment. There is a substantial economic difference between a direct investment and a loan. Ownership, as such, conveys more than a formal "legal title." It provides the owner with the opportunity to monitor and control the asset. A savings and loan association that has a direct investment in a housing project can (indeed, must) monitor the progress of the project. It has or can readily obtain the information necessary to do so (i.e., to determine at all times whether the costs incurred are within the budget, whether the materials used and workmanship performed are as planned, etc.). As demand conditions change, the association has the opportunity and legal ability to change its position in the most efficient and profitable manner. In contrast, a savings and loan association that is a mere lender does not have the opportunity (and often not the right) to monitor a project. Consequently, changing conditions may result in the borrower maximizing its own position at the expense of the lender. These factors make a loan more risky than a direct investment. If the borrower has a very low equity investment, the savings and loan's position is even riskier. This additional risk, however, does not convert a loan into a direct investment; it converts a loan bearing some risk into a loan bearing more risk.

The situation is similar where a direct investment is in a completed property operated by a savings and loan association. As a direct investor, the association has the opportunity to manage investment and adapt its operations to changing conditions. In contrast, where the savings and loan association has a minority position in a joint venture, the majority owner usually has the right to manage the property. This lack of control can put the savings and loan association in a relatively more risky situation. But this added risk, as mentioned above, does not convert the loan or the joint venture into a direct investment.

By lumping direct investments together with loans that bear different types and degrees of risk, the Bank Board is making at least two serious mistakes.

First, it is incorrectly identifying direct investments as risky assets. In fact, the evidence shows that direct investments have been both highly profitable and risk reducing for most savings and loans. (See research studies I presented at the February 27-28, 1985 Hearing**.) By constraining the amount of direct investments allowed to savings and loan associations, the Bank Board has increased the risk of failures and the cost to the FSLIC.

Second, by misclassifying ADC (acquisiton, development and construction) loans and joint ventures with true direct investments, the Bank Board is obscuring critical economic differences between these various investments and consequently failing to identify — or to obtain essential information on — those types of assets that often are highly risky investments. This eventually will frustrate and defeat the regulatory purpose of limiting the risk to the FSLIC, and will impose economically inefficient limits on savings and loan activities. As a review of the AICPA guidelines and the experience of CPAs shows, it often is unclear whether or not a loan should be classified (or at least, for most meaningful economic and regulatory purposes, misclassified) as a direct investment. Because the Bank Board has imposed restrictive limits on that category of assets called "direct investments," savings and loan executives have incentives to structure assets as "loans" in order to force these assets to meet the AICPA guidelines. I believe, for example, that the testimony on the failure of Beverly Hills Savings and Loan (presented before the July 15, 1985 Hearing***) illustrates the strong incentives and the considerable ability of an association to keep loans from being classified as direct investments. Thus, the Bank Board's policy of restricting "direct investments," lumping highly disparate types of assets together, and refusing to alter its regulatory accounting principles will most likely lead to serious distortions in accounting practices and perhaps to the inefficient structuring of association transactions.

These serious mistakes will also combine to create another problem. For the time being, the Bank Board (and the Congress) may be lulled into a false belief that the overly-risky investments of savings and loan associations are being accounted for and, presumably, controlled. This is not the case. Sooner or later, that will become apparent.

3. Question: "In your testimony before the Committee you assert that direct equity investments have not been a major cause in the failure of the thrift institutions you have studied. As an accounting and financial expert, shouldn't your conclusions on this subject be based on the economic reality of the underlying transaction, i.e., whether in an economic sense the transaction was a loan or an equity investment, and not how the transaction is classified for legal purposes?"

Response: In my testimony before the Committee, I showed (not merely asserted) that direct equity investments were not a major cause of the failure of the thrift institutions that the FHLBB had identified as failures. Indeed, the study I presented shows that almost none of the failed associations had losses on direct investments that contributed in more than an trivial way to their demise. My analysis necessarily could be based only on the data that were available publicly. These data define direct investments as equity in service corporations and real estate held for development/investment/resale. It is possible, of course, that some direct investments were misclassified by the failed savings and loan associations. To my knowledge, the Bank Board has not shown this to be the case, and the Bank Board is the only agency which has access to the records that could demonstrate a reporting error, if one exists. Furthermore, all of the studies that the Bank Board has prepared are based on the same data with respect to direct investments that I used.

As I indicated in my response to question 2, I agree that any conclusions on the subject should be based on the economic reality of the underlying transaction. The economic reality is that an asset that is owned — a direct investment — is importantly different from a loan, where the underlying asset is owned by the borrower. The difference is in their relative riskiness — a loan often is more risky. As I indicated above, the Bank Board and the Congress are likely to be misled, to the detriment of both the FSLIC and the taxpayers, by confusing risky loans with direct investments, and classifying them together.

Finally, I would like to ask the committee and the Bank Board my own question about "economic reality": How can you contend that Empire represents the "economic reality" of "direct investments" when Chairman Gray believes that Empire's "loans" -- whether called "direct investments" or five-legged dogs -- were based on "massive fraud" and when the House Committee on Government Operations concluded that Empire's operations appeared to be shot through with fraud? Based on the findings of Mr. Gray and Congress, Empire represents the "economic reality" of fraud, gross negligence, and insider dealing. That particular "economic reality" has no relevance to a serious analysis of the economics of true direct investments. Indeed, an advantage of direct investments over loans such as those made by Empire, is that fraud by insiders is less likely to occur with true direct investments. Unlike loans, earnings on direct investments cannot be recorded until assets are sold in genuine market transactions. Because the property is owned by the association, the profits redound to the association rather than to a developer who might be tempted to offer a bribe to an association officer for making a favorable loan. (See April 25, 1985 Hearing** on Empire for an allegation of this practice.)

4. Question: As a legal matter, the courts and regulatory agencies are often directed to disregard the form of a transaction in order to determine the underlying substance of that transaction. For example, in *Tcherepnin v. Knight*, 389 U.S. 332 (1967), the Supreme Court stated 'in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality.' Other examples of disregarding form and looking at the economic

reality of [sic] transaction abound. See, e.g., First National Bank of Plant City v. Dickinson, 369 U.S. 122 (1969); American Timber & Trading v. First National Bank of Oregon, 690 F.2d 781 (9th Cir. 1982). Based on this legal principle shouldn't certain loan transaction [sic] be classified as direct equity investments regardless of the existence of explicit Bank Board regulations requiring such classification?"

Response: Economic analysis surely should be based on the economic reality of transactions. Based on that principle, loans should not be classified as direct equity investments. A loan generally brings an indirect claim over an asset, while a direct investment is just that, direct ownership of and control over an asset. That is the significant and "real" economic difference. Further, while some loans are less risky than some direct investments, other loans are much riskier than some direct investments. These different classifications do not necessarily indicate the degree of risk involved. In addition, the risk associated with any asset can be measured only together with the association's entire portfolio. As the research I presented at the February 27-28, 1985 Hearing** shows, savings and loan associations' total risk declines as they hold greater proportions of true direct investments. Therefore, for purposes of economic and regulatory analysis, it clearly is incorrect and dysfunctional to classify loans believed to be risky together with true direct investments.

The Bank Board's error in identifying as direct investments loans with low borrower equity loans and loans that turn out to be bad or fraudulent is difficult to understand. Its misperception may have been the result of supervisors' seeing bad loans eventually turn into de facto investments, in the sense that foreclosed property is a form of direct investment. It may have been the result of the supervisors' unfamiliarity with direct investments, which caused them to assume that a loan characterized by a lender's participation in a project's profit necessarily made it a direct investment simply because it was similar to the situation where a property owner obtains rewards from profits rather than from interest. Finally, it also may be the result of the Bank Board's bias towards loans to builders as compared to development and construction by savings and loan associations. While construction by either enhances the availability of housing and other projects to the American public, there is a significant difference. Traditional lending activity yields profits to traditional builders, while direct investments yield profits to savings and loan associations.

In terms of the concerns of the FSLIC and the American taxpayer (who most likely will have to bail out the FSLIC), direct investments should be favored rather than curtailed. True direct investments have not been responsible for failures. To the contrary, they have been both profitable and less risky, on the whole, for savings and loan associations. A sound regulatory program would foster direct investments, avoid obscuring meaningful distinction among assets, and focus on controlling and minimizing fraud, accounting manipulation, and overly "risky" activities whatever their legal or economic nature.

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*April 25, 1984, Hearing before a Subcommittee of the Committee on Government Operations, House of Representatives Adequacy of Federal Home Loan Bank Board Supervision of Empire Savings and Loan Association.

**February 27-28, 1985, Hearing before a Subcommittee of the Committee on Government Operations, House of Representatives, Federal Regulation of Direct Investments by Savings and Loans and Banks: And Condition of the Federal Deposit Insurance Funds. See George J. Benston, "Direct Investments by Savings and Loan Associations: Return and Risk," pp. 505-571, especially Table 1 and Chart 2.

***July 15, 1985, Hearing before the Subcommittee on Oversight and Investigation of the Committee on Engery and Commerce, House of Representative, Oversight on the Accounting Industry and Federal Regulatory Agencies: The Failure of the Beverly Hills Savings and Loan Assocation.

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FINANCIAL CONDITION OF THE BANK AND THRIFT INDUSTRIES

THURSDAY, OCTOBER 3, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
SUPERVISION, REGULATION AND INSURANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Chairman St Germain; Representatives Annunzio, Barnard, LaFalce, Cooper, Wylie, McKinney, Wortley, Bartlett, and Roth.

Also present: Representative Thomas R. Carper of the full committee.

Chairman ST GERMAIN. Today, we hear from the trade associations of the commercial banks, the thrifts, the State regulators. The subject of these hearings—deposit insurance reform—is as complex as it is important. The testimony of today's witnesses, added to that of the academic experts we have heard over the past several weeks, will be of great assistance to this subcommittee as it continues its efforts to weigh the relative merits of the various deposit insurance reform proposals.

Without objection, we will put all of your statements in the record as presented.

I will now call on our first witness, James G. Cairns, Jr., appearing on behalf of the American Bankers Association. Mr. Cairns, you may proceed.

STATEMENT OF JAMES G. CAIRNS, JR., ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION [ABA]

Mr. CAIRNS. Thank you very much, Mr. Chairman. I'm pleased to be here to testify on this very important subject.

To begin, we believe that the system's basic structure, that of an industry-funded pool of resources administered by a Federal agency, remains a sound and desirable means of assuring public confidence and enhancing our Nation's financial stability.

For some time, the ABA has anticipated that the condition of the thrift industry would lead to a discussion of the insurance funds and, for that reason, we established an oversight committee on deposit insurance reform more than 1 year ago.

On September 12 of this year, the ABA board of directors adopted a general policy statement on a deposit insurance reform. Briefly, that statement makes the following major points.

The ABA is of course willing to work to improve the insurance system as it applies to all depositories. The principal focus, we believe, should be first on the FSLIC, where the major problem resides; and, second, the changes in laws and regulations should apply equally to all depositories.

The ABA opposes a merger of the FDIC with the FSLIC because of the inequality of prudential standards and powers that exist between the two industries.

The ABA supports greater market discipline and increased self-discipline.

Mr. Chairman, we are continuing our study of deposit insurance reform and, in the meantime, we encourage moving toward the system of modified payouts to assure equality of treatment of all failed banks.

We believe that the banking industry is sufficiently capitalized and that mandatory capital——

Chairman St Germain. Excuse me. Did you say "quality" or "equality" of treatment?

Mr. Cairns. Equality. Equality of treatment. We think all should be treated the same.

We also think, as I've just mentioned, that mandatory capital increases, including the issuances of subordinated debt, at this time is inappropriate.

We believe that risk-related insurance premiums could be beneficial if implemented in a workable manner.

We do not believe that public disclosure of regulatory enforcement actions is appropriate because we think that if the modified payoff approach were adopted, it would result in a much more effective use of information that's already available.

In looking at the question of deposit insurance reform, the first question we think could be asked should be:

What does it take to maintain a strong insurance fund?

In our opinion, it takes two things. First, it takes a strong banking system. That is, it requires that commercial banks have the opportunity to efficiently serve their customers with financial services and products that maximize consumers' convenience; and contribute to bank profitability.

Need for earnings, however, we believe has to be balanced with reasonable risk, which can be achieved best through the proper diversification of activity and the use of resources.

Second, the bank must be run honestly. We are disturbed at the reports of dishonesty that is apparently ingrained in some of the closures that have taken place. And we think a bank must have capital for it to—sufficient capital—to support its activities.

Wherever there is any dishonesty or impaired capital without a realistic probability of restoration, we think the institution should be closed, and closed promptly.

While these two objectives are laudable, they are not obtainable in our opinion so long as the products and service legislation is not enacted.

Next, we believe the discussion should be focused on several specific issues. First is that of fairness of treatment of all types of financial institutions, regardless of size or charter.

The ABA is opposed to 100-percent deposit insurance coverage as a solution. I mentioned earlier that we urge consideration be given to a modified payoff approach to assure that all depositors receive equal treatment and protection.

In the event it is not practical to close an institution immediately, we favor the concept of establishing an FDIC administered trusteeship to operate the institution until it can be ultimately disposed of.

Depositors would be treated in exactly the same manner under the modified plan as they would under the trusteeship. Legislation establishing that modified payoffs with or without trustees are to be utilized and all financial institution failures would clearly put uninsured depositors and creditors on notice that their funds were at risk.

The second issue is that of capital standards. Our committee does not believe it has been demonstrated that present bank capital levels are inadequate. Further, they are significantly higher than in the thrift industry.

There are those who suggest that bank capital be augmented by subordinated debt. I think we all know that subordinated debt is not the same as equity, and we're very concerned that all commercial banks do not have the same ability to reach the debt markets, to have that same access to capital markets.

The third issue is the proper level of disclosure. A great deal of information about banks is already available, but we believe this information may not be adequately utilized because current practices foster the impression that the risk to uninsured depositors and creditors is low. I think the modified payoff plan would permanantly alter that impression.

The fourth issue is that of risk-related deposit insurance premiums. Many of our members believe that some type of risk-related system should be adopted. However, we're concerned as to the difficulties of implementing such a system and are still working on it.

Chairman **St Germain**. Mr. Cairns.

Mr. **Cairns**. Yes.

Chairman **St Germain**. Just look at your own words: "Some type should be adopted."

Mr. **Cairns**. That's right.

Chairman **St Germain**. Do you know that we have been sitting up here waiting for somebody to tell us exactly what type? I mean, we have had a lot of witnesses testify on this. We have had witnesses who are definitely against any risk-related insurance. I'm sure you're aware of that.

Mr. **Cairns**. Yes, sir.

Chairman **St Germain**. But the big dilemma is what type? Some type is a great term, but keep thinking, and keep studying.

Mr. **Cairns**. Well, I assure you we are. We have not left this issue. And, as I mentioned earlier, we're still working on it. This is, as you just pointed out, a very complicated thing.

Chairman **St Germain**. Sure is.

Mr. **Cairns**. But, I would tell you, as recently as yesterday, we had another committee meeting. We are working on formulas and ideas, and I'm sure we'll have something for you to consider before too long. I don't have it available today. But we do think there is merit to the overall idea, at least.

Chairman **St Germain**. We await it with bated breath.

Mr. **Cairns**. So do we.

We also think that more frequent examinations of problem banks should take place, and we think those banks should pay for those examinations, and that payment process would provide some better approach to allocating the cost of the deposit insurance system.

In regard to risk-related capital requirements, it should be remembered that the regulators today have complete legal freedom to require banks to maintain capital levels higher than the uniform minimum standard.

While we have some concerns again about risk-related capital, again, in this area, we're working on possible solutions to that. And I hope we'll have something for you before long.

The fifth issue is the proper scope of examinations. Detection of fraud, we think, should play a much larger role in the supervision and examination process.

And, finally, there's the issue of merging the FDIC and the FSLIC. As you, I'm sure, would expect, we are strongly opposed to such a merger. We do recognize current strains on the FSLIC. But we believe that merging the FDIC and the FSLIC funds by itself would do nothing to redress the real problems of the thrift industry, particularly when there exists continuing large disparities between capital requirements, accounting procedures, and regulatory treatments of banks versus thrifts.

In summary, we think there's no substitute really for good management of either financial institutions or the regulatory agencies that supervise them and, certainly, the funds that insure America's depositors.

If management does not perform, we think it should be replaced. In this discussion, we suggest several questions need to be answered early on, the first of which is:

Why haven't failed institutions been closed?

Second, why does it take so long to recognize and rid ourselves of those who have committed fraud?

And, finally, why haven't we shored up the ability of commercial banking institutions to sustain a steady stream of income from a diversified base of business?

We believe the best way to assure strong banks and a strong FDIC is to stop pidgeonholing banks and let them compete in the modern financial markets.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Cairns follows:]

Testimony of

JAMES G. CAIRNS, JR.

President of the American Bankers Association

Before

The House Committee on Banking, Finance, and Urban Affairs
Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance

October 3, 1985

Reform of the Federal Deposit Insurance System

Mr. Chairman and Members of the Committee, I am pleased to be able to testify today on the complex but crucial issues of reform of the federal deposit insurance system, and enhancing the safety and soundness of depository institutions through improved examination and supervision as well as greater industry self-regulation. My name is James G. Cairns, Jr., and I am President of the American Bankers Association and President of the Peoples National Bank in Seattle, Washington.

I am here today representing the American Bankers Association whose members hold over 95% of the commercial banking assets in this country.

The ABA commends Chairman St Germain and the Committee for commencing this timely reconsideration of the assumptions underlying the deposit insurance system and re-examination of mechanisms which have been in place for more than half a century. The ABA believes that the system's basic structure — that of an industry-funded pool of resources administered by a federal agency — remains a sound and desirable means of assuring public confidence and enhancing financial stability. And we believe that the FDIC fund remains more than adequate to deal with any forseeable contingency.

Nonetheless, we are aware of Congressional and public concern regarding a series of recent and well publicized financial institution failures. Media images of the anxious depositors of privately insured Ohio and Maryland thrifts have inevitably had some detrimental effect on public confidence in all financial institutions. We are also aware of the continuing severe problems being experienced by many thrift institutions, and the strain which these problems are placing on the FSLIC.

Bankers are also concerned about the efficacy of regulatory supervision, as well as some fairness issues which have been raised by recent occurrences. The failure of the Penn Square Bank demonstrated how brokered deposits could underwrite unwise management strategies, and encouraged the FDIC to experiment with modified payouts. The rescue of Continental Illinois has raised the question of whether some large banks cannot presently be closed by the FDIC, thereby providing large depositors with de facto 100 percent insurance coverage. The structure of Continental's rescue has also suggested the need to enhance the separation between a bank and its holding company's subsidiaries and affiliates so that deposit insurance fund monies do not provide assurances to holding company debtholders. Finally, the continuing capital inadequacy of the thrift industry is a great cause of concern for bankers, both in terms of potential impacts on public confidence as well as the fairness of competition between banks and thrifts.

Because the ABA believes that reform of the bank funded deposit insurance system is an area in which banks should take the lead in order to accomplish any necessary reforms, the ABA established an Oversight Committee on Deposit Insurance Reform and Safety and Soundness in the summer of 1984. This Committee consists of seventeen bankers with expertise in law, economics, and corporate management coming from banks ranging in size from $34 million to over $100 billion in assets. The Oversight Committee in turn selected a team of five highly respected academic consultants who prepared a series of long and detailed studies of the key problems and issues of deposit insurance reform and enhanced safety and soundness. The Oversight Committee reviewed and discussed the studies prepared by our consultants' group, and outlined its reactions and recommendations to the ABA Government Relations Council. The Government Relations Council, and then the Banking Leadership Congerence, reviewed the Committee's work and added their thoughts. This process culminated in the adoption of a general policy statement on deposit insurance reform by the ABA's Board of Directors on September 12.

That statement reads as follows:

While the ABA believes that the present bank federal deposit insurance system is sound and effective, the ABA is willing to work with the Congress and the regulators to improve the depository insurance system as it applies to all depository institutions. However, the ABA believes that the major problem is not in the FDIC, but rather in the FSLIC; and that the focus of the Congress and the regulators should be to address the problems of the thrift industry and the FSLIC.

Any laws or regulations adopted must apply equally to all depository institutions.

The ABA opposes a merger of the deposit insurance funds which would result in banker contributions supporting a thrift industry which is not subject to the same regulatory, capital, and accounting standards as banks and which has the ability to offer a greater array of products and services.

The ABA supports greater market discipline in order to enhance the safety and soundness of the financial system and to ensure fair competition among all depository institutions.

The ABA believes there is a greater role for self-regulation in the industry and is working to develop initiatives in this area.

The Board adopted the following preliminary positions, from which further study and discussions with policymakers should proceed.

o Modified Payoff: The ABA encourages the consideration of a modified payoff approach, with objective criteria, including appropriate steps to ensure a stable transition and equality of treatment regardless of size.

o Increased Capital: The ABA believes that the banking industry has adequate capital. The ABA opposes proposals to mandate increased capital, including proposals to increase capital through the issuance of subordinated debt.

o Risk-Related Premiums: The concept of risk-related premiums is attractive to the banking industry. There is concern, however, over whether such a concept can be implemented in a workable manner. The ABA will actively explore options for a workable method of implementation.

o Risk-Related Capital: The ABA opposes the implementation of risk-related capital because of concerns over the implementation of the concept. In addition, it is unnecessary if market discipline is enhanced through the use of the modified payoff.

o Disclosure: The ABA believes sufficient information should be available in order for market discipline to be effective. However, the ABA is not convinced that additional disclosure is needed at this time, given the information already available; and the ABA therefore opposes additional government-mandated disclosure. Any government-mandated disclosure requirement should apply equally to all depository institutions. The ABA believes that there should be a greater role for self-regulation in the area of disclosure.

o Expanded Examination and Supervision: The ABA believes the regulators should devote greater resources to detecting insider abuse. The ABA supports better training and compensation for regulatory staff.

The ABA has also established a Commission on Safety and Soundness, composed of bank executives from institutions of all sizes and geographic regions, which just held its second meeting. Its primary focus will be to develop proposals for industry self-regulation which can enable banks to better manage risk, and which can enhance public confidence in the banking system. The Commission, which is scheduled to deliver its final recommendations in February, has already determined that in a competitive environment of greater freedom, maximum reliance should be placed upon market discipline and self-regulation as preferable to increased government regulation.

In summary, the ABA is well aware of the need for the banking industry to be in the forefront of developing and recommending policy initiatives which address the issues of deposit insurance reform and enhanced safety and soundness. We look forward to working with Congress in improving the regulatory and competitive framework in which banks operate, by finding the right answers to critical questions.

The first question that should be asked is, "What does it take to maintain a strong insurance fund?"

First, it takes a strong banking system. That is, it requires that commercial banks have the opportunity to efficiently serve their customers with financial products and services that can maximize customers' covenience and contribute to bank profitability. The need for earnings must be balanced with reasonable risk, which can be achieved through proper diversification of activity and efficient use of resources.

Second, the bank must be run honestly, with capital sufficient to suport its activities. Wherever there is dishonesty or imparied capital, without a realistic probability for restoration, the institution should be closed promptly. In our opinion, while these two objectives are laudable, they are not obtainable so long as products and services legislation is not enacted. We believe it is possible that, without such legislation, individual banks may take on excessive levels of risk as they struggle to stay profitable within constricted product lines — creating a risk to the FDIC fund. The single most important thing Congress can do to assure the FDIC's continued strength is to enact legislation enabling banks to maintain their profitability and better serve the public.

While we are aware of the questions of fairness raised by such episodes as the handling of Continental Illinois, we are strongly opposed to de jure one hundred percent deposit insurance coverage as a solution. Such a decision would greatly expand the exposure of the deposit insurance funds while forfeiting the market discipline that could be imposed by the sophisticated investors who place such deposits. Therefore, consideration should be given to a modified payoff approach to assure that depositors in banks of any size receive equal treatment and protection. Under this approach, those with insured deposits in a failed bank would continue to have immediate access to their funds. Uninsured depositors and creditors would receive a pro rata share based upon FDIC estimates of recovery during liquidation. If subsequent recoveries exceeded that estimate, these parties would receive additional proportionate reimbursement.

We recognize that utilization of a purchase and assumption or liquidation might not be practicable in the case of some banks, due to both the difficulty of rapidly assessing the worth of their portfolios as well as potential market disruptions. Therefore, we favor the concept of establishing an FDIC-administered trusteeship to operate the institution pending its ultimate disposition. Depositors would be treated in exactly the same manner as under a modified payoff without a trusteeship, receiving pro rata recovery of uninsured amounts at the time the trusteeship was established. Let me emphasize that this trusteeship would not result in discriminatory treatment of large and small banks — it is an administrative tool to assure that all bank failures result in equal treatment of uninsured deposits.

Legislation establishing that modified payoffs, with or without trusteeships, would be utilized in all bank failures would clearly put uninsured depositors and creditors on notice that their funds are at risk, and provide the necessary encouragement to assure exercise of market discipline. The trusteeship option would eliminate any doubts about the willingness of the regulators to impose losses on those with funds in even the largest banks.

Finally, recognize that there could be transitional problems in moving to these new and uniform methods of handling bank failures. To minimize these problems, the law should guarantee that a minimum percentage of uninsured deposits be recovered, and this guaranteed percentage should be phased down and out over time.

In regard to proposals for higher bank capital requirements, we do not believe it has been demonstrated that present capital levels are inadequate. Further, while utilizing subordinated debt as a portion of this capital level might add some additional market discipline, we are concerned about the ability of smaller banks to market such instruments. The banking regulators, responding to Congress, recently instituted uniform higher capital requirements for all size banks. Utilizing subordinated debt could undermine that uniform treatement. And, while it has been suggested that small banks could sell subordinated debt to correspondents, we question whether that market would exist and fail to see how it would reduce overall risk within the banking system. However, we do believe that banks should have the ability to use subordinated debt as an option in satisfying a protion of their current capital requirements.

While any movement toward market discipline does require adequate disclosure, a great deal of information is already available, and may not be adequately utilized simply because current practices foster an impression that risk to uninsured depositors and creditors is quite low. The key task for policymakers would seem to be providing an assurance of real risk to those market participants capable of utilizing and acting upon this information. If such a risk is assured by the policymakers, the proper disclosure will be forthcoming on a voluntary basis from those who wish to obtain funds exceeding deposit insurance limits.

A great deal of information already exists for those interested in grading the quality of a particular bank, and the primary means of assuring that it is utilized to exert desirable discipline is to increase the market's perception of the risk of unwise funding decisions. The private sector already appears to be acting in this regard as evidenced in an August 6, 1985 Wall Street Journal article (attached) describing the increasing influence of the Keefe Bruyette Bank Watch Service on the placement decisions of institutional depositors. The article also notes that Standard & Poor's has instituted a similar rating service and that other credit rating agencies are preparing to enter this field. In the future, it is less likely that any uninsured institutional depositor would choose an extra few basis points when it requires funding an institution which receives low ratings from multiple credit analysts.

Large institutional depositors must know that public policy dictates that unwise funds placement decisions in any bank can have stinging consequences. While the deposit insurance agencies must protect their fund assets, other policy considerations — such as the rights of management and shareholders, and the importance of an institution to a community — must also be factored into their ultimate treatment of troubled institutions. In particular, the ABA is very concerned about proposals to provide the insurance agencies with authority to require mergers prior to institutional insolvency. At the same time, we believe the agencies should have a broad array of other enforcement and disciplinary tools; and should enhance their monitoring capabilities so as to be better able to close banks at the moment of insolvency — to the extent this can be achieved, the cost of failures to the insurance funds would be greatly lessened. Last, but by no means least, insolvent institutions should not be permitted to operate — we never want to see the FDIC exposed to the dangers that the FSLIC is now facing because it let bankrupt thrifts continue to accept the public's deposits.

We have also reviewed proposals for risk-related pricing or rebating of deposit insurance premiums. The current flat rate system does present problems in that banks with the lowest and highest risks pay the same rates, and there is no incentive to refrain from inappropriate risk-taking. Bankers are naturally concerned about this fairness question. We are also concerned about the difficulties of implementing a risk-related system; but we are hopeful that a workable method of implementation may be found and are pursuing possible solutions. Were such a system to be established, banker input into its administration and risk-rating criteria would be essential to prevent it from becoming a bureaucratically burdensome form of credit allocation and management second-guessing. The FDIC's September 20 discussion paper on risk-based premiums solicits such input. The ABA is actively reviewing and evaluating this document, as are many individual bankers.

Any risk-related system should be objectively calculated and should accord the maximum possible role to industry self-regulatory standards, as opposed to mechanistic regulatory formulas. We cannot endorse a risk-related system which gives federal regulators the power to veto management initiatives or allocate the distribution of credit. Banks can never be free from risk — in fact the service they provide to society is the analysis, evaluation and assumption of financial risk. Risk comes in many different guises, and different types of risk which would be excessive in and of themselves can ameliorate one another within a well-reasoned management strategy. In this regard, it is instructive to remember that one of the least risky assets from a default prospective, home mortgages, resulted in excessive interest-rate risk for the thrift industry because of its overconcentration on this one area of lending. If it is to have any relevance or chance of success, a risk-related system must focus on whether risk is being successfully managed, not on whether it is being avoided.

Also, as banks gain entry to new fields of financial competition, we would be unlikely to support any system which increased capital or insurance premium requirements solely on that basis. Such an "entry tax" approach would be blatantly unfair to banks vis-a-vis other financial sector competitors and would fail to recognize that a banking organization's overall risk will be reduced by its diversification into new lines of financial products and services.

In addition to risk-related deposit insurance premiums, more frequent examinations of problem banks, with the banks being assessed according to time spent for these reviews, might provide a means for discouraging risky strategies and more fairly allocating the costs of the deposit insurance system.

In regard to risk-related capital requirements, you should remember that the regulators today have complete legal freedom to require banks to maintain capital levels higher than the uniform minimum standards. We are very concerned that risk-related capital could end up having serious credit allocation effects. However, we are actively exploring, in our Safety and Soundness Commission, possible uses for a risk-related capital system, probably through a self-regulatory mechanism, which could enhance the safety of banks. Our Commission believes a carefully crafted system, with banker input, may be workable. As noted, we are not convinced that the banking system as a whole is not adequately capitalized. However, implementing a modified payoff system could be expected to result in the market acting to force banks perceived as riskier to maintain higher capital if they wished to attract uninsured deposits.

With respect to examination and supervision, the detection of fraud should play a much larger role in the supervision and examination process. Also, the agencies should expand their use of statistical and computer-based modeling in monitoring and identifying risk, with particular attention to methods already developed by the private sector.

Finally, while we recognize current strains on the FSLIC, we believe that merging the FDIC and FSLIC funds, by itself, would do nothing to redress the real problems of the thrift industry.

There exists continuing large disparities between the capital requirements, accounting procedures, and regulatory treatment of banks versus thrifts. For example, while insolvent banks are closed immediately, an FHLBB study shows that one out of seven FSLIC-insured institutions now operating are technically insolvent. And an ABA economic comparison of banks and thrifts shows that, as of December 1984, commercial bank primary and secondary capital stood at 6.76% of assets, compared to 0.91% for FSLIC-insured thrifts. Bankers welcome competition — but is it fair competition when the thrift across the street is insolvent and has greater powers to boot? And should bankers subsidize this inequality through a merger of the insurance funds?

The runs on privately insured thrift institutions in Ohio and Maryland have demonstrated the weakness of privately funded and administered deposit insurance funds in a time of crisis. Nonetheless, private insurance systems may have some useful role to play in providing supplementary coverage above the statutory deposit insurance limits, both as a means of enhancing the stability of the financial system and for imposing yet another lever for market discipline. This appears to be one area where the market will act on its own, without any need for legislative sanctioning.

CONCLUSION

Because of the great importance of the deposit insurance system and the need to fine tune it in view of new marketplace realities, the ABA initiated steps last year so that the banking industry can take the lead in proposing desirable and workable solutions. We hope that any legislation resulting from these hearings will provide sufficient assurances of banking system discipline to better pave the way for continued financial deregulation — and will not impose new regulatory constraints on banking institutions which leave them less viable in the competitive environment we face for the rest of this century.

Deposit insurance reform can do much to encourage a healthy banking system, but it cannot guarantee a healthy banking system. The only assurance of bank health is bank profitability, and profitability depends upon remaining fully competitive. We would hope that deposit insurance reform would lead to a system which better rewards prudent and effective management, and which provides disincentives for excessively risky strategies. However, we cannot expect deposit insurance reform to save those institutions which have gone past the point of no return. Nor can we expect it to assure the profitability of the banking system in a rapidly changing, competitive environment.

In short, we must have reasonable expectations of what insurance reform can and cannot accomplish. It can provide for greater fairness, worthwhile incentives, more accurate appraisals, and more timely intervention. But it cannot enhance the bottom line profitability which is the ultimate insurer of bank health. Nor can it or should it prevent all bank failures. Interest rate deregulation inevitably increased the penalties for asset/liability mismanagement, and created a more competitive environment. But these difficulties are more than offset by the public benefits of market rates and the enhanced overall competitiveness of the banking system. We think that the regulatory structure and its resources can largely handle the challenges of a market-oriented financial system now, but that deposit insurance reform can further enhance the efficiency and fairness of the financial marketplace.

However, deposit insurance reform will not change the fact that commercial banks must compete against thrift organizations operating with many more opportunities for diversification and the generation of fee income. It is time, in fact past the time, when commercial banks should be permitted to bolster their fee income and serve the public through such low-risk activities as insurance and realty brokerage, activities which thrift institutions are already free to engage in.

Deposit insurance reform will also do nothing to change the fact that traditional commercial bank assets are increasingly being securitized. The top tier of commercial and industrial firms in the United States, which formerly constituted the top quality loan customers of the commercial banking industry, now raise the vast majority of their short term funds in the commercial paper market. In fact, there is now slightly more commercial paper outstanding than there are commercial and industrial loans extended by commercial banks. The next lower rung of corporate America is now exhibiting a similar pattern through the issuance of "junk bonds", which are really higher interest bearing, lower quality commercial paper. Thirty percent of residential mortgages are currently being securitized and this trend is likely to continue. Other types of debt instruments, such as automobile loans and consumer receivables, are beginning to be packaged into securities for resale in the secondary market. And, of course, money market mutual funds remain an attractive functional equivalent to transaction accounts for many individuals and permit securities firms to offer customers the functional equivalent of banking in tandem with securities brokerage and investment advice.

We're not here to argue that Congress should step in and stop the securitization process. The market place is driving this process, because securitization generally offers a lower cost of raising funds than traditional debt finance. Our concern is that banks are not being permitted to follow and serve their traditional customers as the market place evolves. It is particularly ironic that higher capital requirements are increasingly being proposed as a solution to banking's problems, when the efficiency of the securitization process — and its ability to offer lower financing costs to traditional bank borrowers — is based on its more efficient use of less capital to leverage an equivalent amount of credit. We need to ask whether the $52 billion cost (St. Louis Federal Reserve Bank estimate) to banks, and ultimately to the economy, of moving to a 9% capital standard is the most rational response to whatever need exists to reduce FDIC outlays and impose desirable discipline.

Further, while recent court decisions have at least temporarily shelved the nonbank bank loophole as a device for geographic expansion by bank holding companies, the loophole remains open for commercial and industrial firms seeking to acquire state banks to gain access to the payment system and FDIC insurance coverage. The Congress has yet to close the nonbank bank loophole, and even the bill which recently emerged from your Committee would grandfather the presence in the banking system of such insurance companies as Kemper, Prudential, and Travelers; of such securities firms as Fidelity, Shearson/American Express, Dreyfus, and E.F. Hutton; and of financial conglomerates such as Gulf & Western, Household International, Beneficial, J.C Penney, and Control Data Corporation's Commercial Credit Division.

Finally, despite all the public policy commitments to maintaining the separation of banking and commerce, we take note of recent news stories that General Motors Acceptance Corporation has become the second largest mortgage banking firm in the United States; that the Chrysler Financial Corporation recently acquired the E.F. Hutton Credit Corporation, a specialist in equipment and leasing financing; that Metropolitan Life is acquiring Century 21 in order to combine realty brokerage, mortgage banking and insurance; and that Ford Motor Company has agreed to acquire First Nationwide Financial Corporation, at nearly $11 billion in assets the eighth largest thrift institution in the United States. Anthony M. Frank, First Nationwide's Chairman and CEO, displayed little concern about Congress' threatened limitation of tandem operations when he stated upon announcement of the proposed acquisition, "teaming us with Ford Motor Credit, the world's second largest consumer finance company, will enable Ford to serve the broad middle class of our country by offering financing for two of the largest purchases that most families ever make — their home and their auto".

I would submit, Mr. Chairman, that the commercial banking sector cannot remain strong over the long term unless it can build upon its existing mandate in order to freely and fairly compete in the modern financial marketplace. While insurance firms, securities underwriters, and auto companies continue to expand their financial services and presence in the depository system, bankers continue to be denied even the most modest entry into financial products and services areas where risk is quite manageable, and where customer demand is quite evident. If Congress wants to ensure bank safety and soundness, it should let us compete in this real world marketplace.

In conclusion, the ABA stands ready to propose and support reforms of the deposit insurance system which will make it more responsive and attuned to the new competitive environment. At the same time, we remain committed to removing legislative and regulatory restrictions which deny banks the opportunity to remain sound over the long term by being fully competitive in the dynamically changing financial environment we face today.

Ultimately, there is no substitute for good management of financial institutions, of the regulatory agencies which supervise them, and of the funds which insure America's depositors. If management does not perform it needs to be replaced. However, don't throw out the baby with the bathwater. The basic system we have if fifty-plus years old, and has served us well. But there are several questions that should be asked:

1) Why haven't failed institutions been closed?

2) Why does it take so long to recognize and rid ourselves of those who have committed fraud?

3) Why haven't we shored up the ability of commercial banking institutions to sustain a steady stream of income from a diversified base of business?

The final question we all need to ask is:

4) Where do we go from here?

Thank you.

This concludes my statement. I would be pleased to respond to any questions.

6 THE WALL STREET JOURNAL TUESDAY, AUGUST 6, 1985

Bank-Rating Service's Influence Grows

Big Depositors Rely, Some Say Blindly, on Keefe Bruyette

By Jeff Bailey and G. Christian Hill
Staff Reporters of The Wall Street Journal

With about $5 billion to invest on a short term basis, Alex Laird, a first vice president of Hutton Asset Management, gets a lot of calls from deposit-hungry banks. But don't bother calling the money manager for the E.F. Hutton Group Inc. unit unless your bank's rating is at least a C on the Keefe, Bruyette & Woods scale of A to E—Mr. Laird won't even consider it.

"We do cursory research," Mr. Laird says. "That's why we rely on Keefe."

It's a similar story at the Federal Home Loan Bank of Chicago. "We rely on the Keefe ratings to determine who we'll sell funds to," says Paul J. Bielat, treasurer, with about $2 billion deposited in banks. Mr. Bielat says the regional home loan banks, in varying degrees, build the Keefe ratings directly into their investment policies.

Ratings Service's Influence

The reliance of these two big money managers on the ratings illustrates the growing influence of Keefe's bank rating service, known as Bank Watch. The New York based bank securities firm rates the 300 largest U.S. banks, 100 big foreign banks and a growing number of thrifts. The 450 Bank Watch subscribers, like Messrs. Laird and Bielat, include many of the biggest sources of bank deposits. In addition to money market funds and the Federal Home Loan Bank system, cash rich corporations, municipal treasurers, insurance companies, foreign central banks and bank trust departments buy the Keefe service.

And many of these institutions follow almost blindly the Keefe ratings in choosing where to deposit their money.

For banks, the existence of a single service that can so broadly influence funding customers only adds to the already high level of skittishness in world financial markets. That skittishness was demonstrated by huge depositor runs last year at Corp. of America. Some bankers now worry that Keefe's Bank Watch service, coupled with nervousness, could spark a run on a less feeble institution.

An Impact Beyond Subscribers

What's more, Keefe's ratings can have an impact even beyond its subscribers. After a rating change, says Bruce Trottier, a Drexel Burnham Lambert Inc. vice president managing $1.5 billion, bank certificate-of-deposit traders often catch wind of it and pass it along to other money managers. "And then there's a ripple effect," with nonsubscribers reassessing the bank, too.

The ratings (see chart) range from A, "Unquestioned strength, no perceived credit risk at any maturity," to E, "Very serious problems . . . Continued viability without outside assistance must be seriously questioned," according to subscribers. Subscribers typically get ratings on 75 or more institutions, and Keefe charges $100 annually for each of these ratings. Gregory Root, the Keefe vice president who oversees the 15 Bank Watch analysts, refuses to confirm any ratings or how they're defined—Keefe tries to keep Bank Watch confidential. Mr. Root says the ratings by themselves could be misleading because Keefe also sends clients a two-to-four page commentary on each bank it rates.

But interviews with Keefe subscribers indicate it's the ratings they act on—not the commentary. "We don't put money in a bank with a D in its rating," a money manager who handles more than $7 billion says flatly.

Conflict-of-Interest Question

For Keefe, Bank Watch's ability to affect the fortunes of a particular institution raises a thorny conflict-of-interest question: Keefe also trades bank stocks, which

(Continued) 4

Keefe Bruyette Rates the Banks

Keefe Bruyette & Woods Inc. Bank Watch ratings for the top 15 U.S. banks

BANK	CURRENT RATING*	CHANGE FROM	WHEN CHANGED
Citibank	A/B	B	Nov. 1984
Bank of America	C/D	C	June 1985
Chase Manhattan	B/C	B	Nov. 1983
Manufacturers Hanover	B/C	B	Nov. 1983
Morgan Guaranty	A	Unch.	
Chemical	B	B/C	Apr. 1985
Security Pacific	B	A/B	Nov. 1983
First Interstate	B	A/B	Nov. 1980
Bankers Trust	B	B/C	Dec. 1982
First Chicago	C	B/C	Oct. 1984
Mellon	B	A/B	Sept. 1984
Continental Illinois	D	E	Sept. 1984
Wells Fargo	B/C	B	Mar. 1981
First Bank Minneapolis	B	A/B	Apr. 1984
Crocker National	C	B/C	Nov. 1983

*As of early July

Source: Keefe Bank Watch subscribers, bankers

What the Bank Watch ratings mean:

A-Unquestioned strength, no perceived credit risk at any maturity level.

B-Very strong credit with little or no credit risk at any maturity level. Any unexpected earnings problems would most likely be of a very short-term nature and should not materially affect the credit standing of the company.

C-Average statistical and operating credentials with one or more problems preventing a higher rating, or a situation where weak elements are counterbalanced by other areas of strength. A sound credit with little perceived short-term risk and only modest risk at longer maturities.

D-One or more operating problems of a material nature have already or may in the future hamper the competitive posture of this organization for a period of time. Some credit risk in the short-term area with increasing degrees of risk at longer maturities.

E-Very serious problems will prevent the company from offering any real competition for a period of time. Risk at all maturity levels must be considered real. Continued viability without outside assistance must be seriously questioned.

(Continued)

can rise and fall on the news of a Keefe rating change. And Keefe often is given earnings projections and other inside information by banks making a case for a rating.

Harry V. Keefe Jr., chairman of the firm, acknowledges the potential conflict but says his firm has taken steps to make sure it doesn't trade on these advantages. He says Bank Watch analysts don't share their information with traders and others at Keefe. And when Mr. Keefe gets personally involved in a rating, as he did recently with First Chicago Corp. and BankAmerica Corp., he says the firm won't trade the stock of that bank for a period of time and that it freezes any shares it already owns.

The conventional credit rating agencies, which don't trade securities, are hoping to take advantage of concerns over Keefe's potential conflict. Standard & Poor's Corp. recently began marketing a service similar to Bank Watch. Moody's Investors Service Inc. and Fitch Investors Service are eyeing the business. And Duff & Phelps Inc. and McCarthy Crisanti & Maffei also are rating banks' deposits. But for now, says Drexel's Mr. Trotter, "Keefe is the service that has the impact."

That's why Barry F. Sullivan, First Chicago's chairman and chief executive, was in New York one day last June to lobby Mr. Keefe. After a $71.6 million third-quarter loss last year led Keefe to downgrade its rating to C from B/C, the parent company of First National Bank of Chicago had seen a multibillion-dollar chunk of its deposit-gathering strength erode. After a big loss on a Brazilian bank investment again had rocked First Chicago's reputation, Mr. Sullivan was hoping to avoid a further downgrading, to C/D, which would drive away still more big depositors.

The two men discussed the recent problems and First Chicago's future prospects. And Mr. Sullivan, according to Mr. Keefe, went so far as to disclose that First Chicago plans to boost its loan-loss reserve by year's end so that it's equal to 60% of the company's nonperforming loans, up from about 45% at June 30. First Chicago wouldn't comment on any talks with Mr. Keefe.

The C rating was affirmed—but there was a warning. "If he or First Chicago makes another error, they'll go to a C/D," Mr. Keefe says he told Mr. Sullivan. "He's at risk and it's up to him to get his funding lines in order."

Concern Over an Apparent Boost

To another big banking concern with troubles, it looked as if Mr. Sullivan's lobbying gave First Chicago an unfair boost. Samuel Armacost, chairman and chief executive of BankAmerica, says he was "incensed" that Keefe lowered his Bank Watch rating to C/D from C, yet left First Chicago's a C.

After his projection of a break-even second quarter led to Keefe's downgrading—but before he shocked the banking industry by instead reporting a second-quarter loss of $338 million—Mr. Armacost asserted in an interview that BankAmerica was stronger than First Chicago by most measurements of financial soundness. First Chicago wouldn't comment on that assertion.

Mr. Keefe, however, says, "I'd be glad to debate Mr. Armacost on that." Noting that his downgrading came before the parent of Bank of America reported the huge loss, Mr. Keefe adds, "I'd say Keefe, Bruyette & Woods was a little better tuned into the situation than Bank of America management was. Maybe (the rating) wasn't low enough."

The rating clearly is less important to BankAmerica than to First Chicago. The San Francisco-based bank's California branch system brings in the nation's biggest supply of stable consumer deposits, while First Chicago relies mostly on deposits from institutions. "Bank of America isn't as sensitive," Mr. Keefe says. "They visited me on the telephone. So they lose a few billion dollars (in commercial deposits)—it's not as important."

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Chairman St Germain. Thank you, Mr. Cairns.

Now, we'll hear from B.F. Backlund, on behalf of the Independent Bankers Association of America. Mr. Backlund, you may proceed.

STATEMENT OF B.F. [CHIP] BACKLUND, ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA [IBAA]

Mr. Backlund. Thank you, Mr. Chairman. I appreciate this opportunity to participate in these hearings. In my view, this is a matter that should have been taken up first in the deregulatory process rather than the last.

But, in a general sense, our deposit system, insurance system, has worked well. It is the rock upon which the Nation's entire financial system is built. Nonetheless, in light of recent events, of which all of you are aware, it is appropriate that you consider and reexamine the Federal Deposit Insurance Act at this time.

In regard to the modified payoff, the IBAA would support a plan that would provide in cases of failure that all uninsured depositors would incur a loss no matter how large the bank.

To put it succinctly, the element of fairness is rapidly disappearing from our deposit insurance system.

On subordinated debt capital, we strongly oppose the FDIC's proposal that all banks be required to maintain total capital of 9 percent, of which 3 percent could be in the form of subordinated debt; because it is infinitely easier for money center banks to raise subordinated debt, this regulation would place community banks at another serious competitive disadvantage.

On risk-related deposit insurance premiums, we suggest that a system be instituted consisting of two components:

The first component would be correlated to the bank's unique financial condition as established by the rating system now known as the CAMEL system.

The second would be based upon systemic risks that a bank poses for the deposit insurance fund as a whole. This factor would be measured by the potential draw that a bank could make upon the funds' resources in the event of its failure. It would include assessments on foreign deposits and take off-balance-sheet items into account.

In short, the bigger the risk that an institution poses to the funds' resources, the higher its premium should be.

Chairman St Germain. Now you just said "assessments on foreign deposits".

Mr. Backlund. Right.

Chairman St Germain. Do the Independent Bankers feel that there should be premiums paid on foreign deposits at all times?

Mr. Backlund. Yes, we do. We feel that those are part of the risk, particularly in the very large banks, under the present conditions. That is part of the risk the fund is expected to meet.

Chairman St Germain. Like a bank that's operating in, let's say, 57 countries?

Mr. Backlund. Right.

Chairman St Germain. You feel that that's part of the risk?

Mr. Backlund. Right.

Chairman **St Germain**. Thank you.

Mr. **Backlund**. On risk-related capital requirements, we have noted with interest the proposals that have been discussed recently, particularly Chairman Volker's. They should be seen as an alternative to across-the-board 9-percent capital requirements. In fact, acting Comptroller Selby noted recently that an across-the-board net capital requirement does not make economic sense. We agree with that. He indicated that his Office is considering a more sophisticated approach, which would take a number of risk factors into account, including off-balance-sheet activity.

So we strongly recommend that the regulators thoroughly consider a more pragmatic and realistic plan before moving ahead.

On insurance fund recapitalization, true, the FDIC Fund appears to be adequate and is growing; however, since the Fund has taken on major new responsibilities, such as Continental-Illinois, and is seemingly unable to apply the modified payout system to money center banks, any thought of restructuring, we think, is premature.

On the merger of the insurance funds, we agree with ABA that we're strongly opposed to that. In our view, this would be harmful to both industries and to the public. And, believe it or not, this may be the one issue on which all bankers agree.

On 100-percent deposit insurance coverage, we are basically opposed to that.

Chairman **St Germain**. I am going to say that gives me cause to want to look into it further. If all of you agree, there's got to be something wrong. [Laughter.]

Mr. **Backlund**. I'm sorry I brought it up in that case. [Laughter.]

But we basically oppose 100-percent coverage, but unless reforms are adopted, which I've just referred to, then this level of coverage should be extended to all banks. If the big banks have 100-percent coverage, then we should have it, too.

On reduced deposit insurance coverage, we believe that the $100,000 level is sound and should be retained. On increased disclosure, we of course are very disturbed by that. Our executive committee has authorized a suit to be filed against the FDIC to challenge their new regulation.

While such a regulation theoretically sounds as though it would instill greater market discipline, these proposed rules would harm both poorly managed and well-managed institutions, and all you have to do is look at the recent events in Ohio and Maryland to see what might come about.

On intensified supervision, we think this is an extremely important issue. Many of the problems which the FDIC is attempting to solve through their disclosure and subordinate debt proposals can be better addressed through improved bank examinations, better supervisions of problem banks, and particularly, better anticipation of problems by the regulators and stronger enforcement action once they have smelled something rotten in Denmark.

Chairman **St Germain**. Mr. Backlund.

Mr. **Backlund**. Yes.

Chairman **St Germain**. The testimony from the regulators, those people who appeared on behalf of the regulatory agencies to date, all point out the fact that as far as examination and supervision are concerned, personnel turnover is just unbelievable. I mean, it's probably one of the biggest turnover rates of any profession that you can think of.

So we appreciate your comment, and I think Mr. Cairns probably agrees with you, that intensified supervision would be helpful. Now, I would like to ask both of you and your colleagues at the table to give us some suggestions as to how we can assist the regulatory agencies in not only obtaining personnel that are adequately trained, but keeping them.

Would you agree that the banks shouldn't pirate these people away from the regulatory agencies? And instead of that, that there should be a higher level of remuneration for them. Also, how would you propose that this be effectuated?

I'm very serious about it because it's a serious problem with all of the regulatory agencies.

Mr. **Backlund**. I can appreciate that. I was a bank examiner in the middle fifties in Nebraska and my salary was $300 a month, and we had $10 a day for expenses, including gas.

And I didn't stay a bank examiner too long. [Laughter.]

But, certainly, that is a problem.

One of the things that I think could be done would be to make the regulatory agencies less politically sensitive. I think when they get into these situations, like the Butcher situation, the Continental situation, the Ohio and Maryland situations, that because of political considerations, these regulators are reluctant to come down early and hard as they should.

And that is why we think it is so important that any reform of the regulatory structure insulate it as much as possible from political influence.

And I am talking about having the management body, the governing body, the board, or whatever, as much as possible removed from politics, with staggered terms and that sort of thing. And that is the extra dimension that I am proposing to deal effectively with these problems and deal with them early.

Chairman **St Germain**. Excuse me. When you say take them out of politics, staggered terms, are you talking about the members of the FDIC?

Mr. **Backlund**. Well, the members of the FDIC Board are insulated to a certain extent but the ideal is the Federal Reserve Board, which has staggered terms and a number of members. I think that type of management body of regulatory agencies will be a lot more effective in dealing with problem situations than the single regulator who is beholden to the current administration of the State or of the National Government. I think that is very important.

Chairman **St Germain**. Have you observed over the years, as I have observed over the years, that one of the last things a new administration takes care to look at are the FDIC, the FSLIC, and the Comptroller's Office? These seem to be throwaways. You know, when everything else is done, when they have appointed the dog officer and everything else, then they get around to the regulatory agencies.

I am serious. Have you noticed that?

Mr. **Backlund**. Well, I have——

Chairman **St Germain**. This is bipartisan. I am not being partisan about this.

Mr. **Backlund**. No, no.

Chairman **St Germain**. Democrat and Republican have both been guilty of this over the years.

Mr. **Backlund**. Right, right.

Chairman **St Germain**. I have to get that one in because it has bothered me for years.

Mr. **Backlund**. Well, that appears to be the case, although I think the two appointees they have up to now are certainly seasoned, capable people. But I think the whole system could be reformed in such a way that it could deal more effectively with the problems that we have.

On market value accounting, we think this has theoretical merit, and perhaps we would have all been better off if it had been the norm in banking. But given the current conditions, such an idea could only be phased in over a long period of time.

Private deposit insurance, we agree with several members of the committee who said recently that deposit insurance, private deposit insurance, is an idea whose time has come. It is really the only viable body for having the deposit insurance or supporting it—is the Federal Reserve and the U.S. Treasury, at least as it appears at this point in time.

Brokered deposit restrictions, we do not believe that these deposits that are essentially large CD——

Chairman **St Germain**. Excuse me, Mr. Backlund. You confused us.

Mr. **Backlund**. All right.

Chairman **St Germain**. First, regarding private deposit insurance, you say its time has come?

Mr. **Backlund**. Its time has gone.

Chairman **St Germain**. Gone, oh.

Mr. **Backlund**. I must have misspoke.

Chairman **St Germain**. You did say "gone." I am sorry.

Mr. **Backlund**. Yes.

Chairman **St Germain**. Because the witnesses from the insurance industry say, spare us, we don't want any part of it.

Mr. **Backlund**. Right, and I agree with that. I am sorry, I misspoke there.

On brokered deposit restrictions, we do not believe that these deposits, which are essentially large CD's broken up into $100,000 chunks, are entitled to the protections designed for small depositors—if you will, the little old ladies from Peoria in tennis shoes. They are the ones that should be protected.

Insurance premiums on foreign deposits. As I stated, we think that there should be an assessment for foreign deposits in the insurance premiums.

And I think that covers all your 14 points, Mr. Chairman. I thank you for letting us appear today.

[The prepared statement with attachment of Mr. Backlund, on behalf of the Independent Bankers Association of America [IBAA], follows:]

TESTIMONY

of

B.F. (Chip) Backlund
President
Bartonville Bank
Peoria, Illinois

and

President
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

on

Deposit Insurance Reform

Before the
Subcommittee on Financial Institutions Supervision,
Regulation and Insurance

House Committee on Banking, Finance and Urban Affairs

Washington, D.C.
October 3, 1985

Mr. Chairman and members of the Committee. My name is B.F. (Chip) Backlund and I am president of the Independent Bankers Association of America (IBAA), a national trade association representing 7,500 commercial banks throughout the nation. I also serve as president of the Bartonville Bank, a $36 million bank near Peoria, Illinois.

I appreciate the opportunity to participate in this morning's hearings. The Committee is to be commended for recognizing the need for deposit insurance reform. In my opinion, these hearings are long overdue.

Mr. Chairman, it would not be an overstatement to say that deposit insurance is the rock upon which this nation's entire financial system is built. Since the Great Depression, the FDIC shield has served as an enduring emblem of confidence that every bank depositor recognizes and depends upon. It now stands for the simple proposition that in the event of a bank failure, all depositors will be fully protected up to $100,000 on their deposits. For 50 years, this system has worked extremely well, even under the recent strain of a record number of bank failures. Nevertheless, it is appropriate that Congress should take the time to reexamine the Federal Deposit Insurance Act and to take steps to strengthen it and render it more efficient and equitable for all bank depositors.

Your letter requesting testimony on deposit insurance reform asked the IBAA to comment on fourteen specific proposals. Today's testimony covers each of them in brief. Our recent testimony before the Senate Banking Committee discusses some of them in more detail, and I ask that it also be included in the record of this hearing.

Modified Payoff:

The IBAA would support a modified payoff plan that would provide, in cases of failure, that all uninsured depositors would incur a loss, no matter how large their bank.

Within the past 18 months, we have witnessed the development of a *de facto* two-tiered banking system, in which one of the nation's largest banks, Continental Illinois, "failed", yet none of its uninsured depositors lost any of their deposits. During this same period, more than 20 smaller FDIC-insured banks failed, in which uninsured depositors lost significant amounts of their deposits, either through straight liquidation or what the FDIC termed a "modified payout" experiment, under which uninsured depositors were treated the same as if the banks had been liquidated.

To put it succinctly, the element of fairness is rapidly disappearing from our deposit insurance system. As the former Comptroller of the Currency, C. Todd Conover, admitted last year at the Continental hearings, we have now reached the point in this country where some banks are "too big to fail." The reverse of this is also true as demonstrated by the use of the modified payout in smaller-sized banks; many community banks are "too small to save."

It is hard to overstate the long-range significance of this new system. On the one hand, the federal government has, in effect, announced that it will not only fully insure all deposits at the nation's largest money center banks, but these banks' other general creditors as well--a tremendous obligation by anyone's standards. Where is the market discipline for the Continental-sized banks?

Please do not misinterpret my remarks as suggesting that I am opposed to the action that was taken by the FDIC to save Continental or, conversely, that the FDIC should guarantee all uninsured depositors of small banks. What I am saying, to the contrary, is that all uninsured depositors over the $100,000 limit should be treated similarly, if not equally. We must re-shape the FDIC so that depositors over the $100,000 threshold in the large bank failure situations will always suffer some degree of loss. I suggest that this Committee formally request the FDIC to provide it with a set of legislative and regulatory alternatives for extending the modified payout concept to all bank failures. Until this happens, the FDIC's "experiment" should be terminated.

Subordinated Debt Capital:

We very strongly oppose the FDIC's proposal that all banks be required to maintain total capital of nine percent, with up to three percent allowed in the form of subordinated debt.

While all insured banks should maintain healthy levels of capital, the use of subordinated debt poses serious problems for many of this country's smaller commercial and agricultural banks. Subordinated debt is simply not a viable vehicle for community banks, because little, if any, market exists for such debt and the costs of issuing it is too high. Therefore, small banks would be compelled to seek equity capital to meet the 9% level, a far more difficult proposition. Because it is easier for money center banks to raise subordinated debt, this regulation would place community banks at a serious competitive disadvantage.

Risk-related Deposit Insurance Premiums:

As another way to help solve the "too big to fail" problem, we suggest that a system of risk-based insurance premiums be instituted, consisting of two components.

The first component would be correlated to a bank's unique financial condition, as established by a rating system similar to the present CAMEL system. The second component would be based upon the systemic risk that a bank poses for the deposit insurance fund as a whole. This factor would be measured by the potential draw that a bank could make upon the fund's resources in the event of the bank's failure. It would include assesments on foreign deposits and take off-balance sheet items into account. In short, the bigger the risk that an institution poses to the fund's resources, the higher its premiums should be.

Last month the FDIC made a specific risk-based proposal. Though the appropriate IBAA committees have not had a full opportunity to analyze it, we believe it is very helpful to have the agency's specific ideas on record. Without making a final judgement, let me make a few preliminary comments. First, the program increases insurance costs after problems arise. Second, it does not take into consideration off-balance sheet activities, such as standby letters of credit, loan commitments and interest rate swaps. Finally, it does not propose assessments on foreign deposits.

Risk-related Capital Requirements:

We have noted with interest the proposals for risk-related capital that some have discussed recently. They should be an alternative to the across-the-board 9% capital requirement that the FDIC has already proposed. Acting Comptroller of the Currency Joe Selby noted recently--quite correctly--that an across-the-board net capital requirement may not make economic sense. He indicated that his office is considering a more sophisticated "risk asset approach" which would take a number of risk factors into account, including off-balance sheet activity. We strongly recommend that the regulators thoroughly consider such a broader-based approach before moving ahead with across the board capital requirements.

Insurance Fund Recapitalization:

The FDIC fund is adequate and growing. However, since the fund has taken on major new responsibilities such as assisting Continental Illinois and is unable to apply the modified payout system to the money center banks, any thought of restructuring it is premature. Once needed reforms are put in place, including charging premiums on foreign deposits and on off-balance sheet liabilities, the size of the fund should be carefully evaluated.

Insurance Fund Merger:

We are very strongly opposed to merging the FDIC and FSLIC. The IBAA recognizes and strongly supports maintaining the unique character of the savings and loan industry in meeting this country's housing needs. As long as fundamental functional differences exist between commercial banks and thrift institutions, the insurance needs and capabilities of the two industries will differ. In our view, a merger of the FDIC and FSLIC funds would be harmful to both industries and to the public. Our Association, and I am confident the rest of the banking industry, would fight this with all our resources.

100% Deposit Insurance Coverage:

Under current procedures the largest banks are deemed "too big to fail," providing their depositors with 100% insurance coverage. We oppose 100% coverage, but unless reforms are adopted to deal with this inequity, this level of coverage should be extended to all banks. Otherwise community banks face the distinct possibility that depositors will withdraw their funds over $100,000 and put them into the fully protected institutions.

Reduced Deposit Insurance Coverage:

The $100,000 coverage level is sound and must be retained. It is currently high enough to meet the goals of deposit insurance--protecting individual savers and this safety net must not be reduced. Indeed, as IRA and Keogh accounts grow over the years, some moderate income savers may begin "bumping" the limit.

Increased Disclosure:

We are tremendously disturbed by the FDIC's proposal to require increased disclosure of financial information and enforcement actions taken against banks by the FDIC. While such a measure theoretically sounds as though it would instill greater market discipline, these proposed rules would harm both poorly-managed and well-managed institutions.

First of all, it is well known that smaller institutions are more often the target of formal regulatory action, simply due to their size and lesser capacity to defend themselves legally against the government. Such a regulation would result in the false public perception that smaller institutions are somehow less safe. Second, the financial information currently available to the public is sufficient for most investors to evaluate a bank's condition and to place their money accordingly. Third, more disclosure across-the-board will likely encourage runs on smaller institutions. Fourth, such action by the FDIC discriminates against state nonmember banks since the OCC and the Federal Reserve are not requiring the same degree of disclosure by banks under their supervision.

Intensified Supervision:

Many of the problems which the FDIC is attempting to solve through their disclosure and subordinate debt proposals can be better addressed through improved bank examination, better supervision of problem banks, and stronger enforcement action, rather than through burdensome across-the-board regulation. I believe that one reason for weak supervision is the fact that some regulators are too politically sensitive and are reluctant to come down hard on certain institutions. This is why it is so important that any reform of the regulatory structure insulate it from political influence.

Market Value Accounting:

We do not believe that market value accounting proposed by several academic witnesses that appeared before this Committee will solve all our problems. It has theoretical merit and perhaps we would be better off if it had been the norm in banking. But given current conditions it could only be phased in over a long period of time.

In a sense, market value accounting is already used by bank examiners. To the extent practicable, examiners now look at the market value of assets and funds when evaluating a bank. This is done to get a true picture of the bank's condition. However, to impose a blanket rule now would subject banks to a substantial increases in their costs. Many assets do not have a readily-determinable market value, while others--such as real estate--would have to be professionally appraised on a regular basis for completion of accurate financial statements.

Private Deposit Insurance:

Though we have explored the possiblity of private supplemental insurance, we unfortunately have to agree with the comments of several Members of this Committee who said recently that private deposit insurance is an idea whose time has gone. Only the broad base and the Federal Reserve's liquidity backstop provided by the federal system provides the nation's depositors with the level of confidence that is essential to preserve our diversified financial system. The private insurance industry simply lacks the resources to take on this task.

Brokered Deposit Restrictions:

The IBAA has supported Chairman Isaac in his effort to limit the indiscriminate access by banks to "hot money" by denying deposit insurance for such funds. We do not believe that these deposits--which are essentially large CDs broken up into $100,000 chunks--are entitled to the protections designed for small depositors. In addition, we have supported the FDIC's monthly reporting requirements, by which banks with brokered deposits in excess of their total capital or five percent of total deposits must file monthly reports with the FDIC.

Insurance Premiums on Foreign Deposits:

We believe it is essential that foreign deposits be included in the assessment base for insurance premiums. As FDIC Director Irvine H. Sprague stated recently in an excellent speech on this issue:

> While the assessment rate has been essentially unchanged in statutory amount since our beginning over 50 years ago, the total liabilities and funds generation apparatus of banks have undergone significant change. One example: deposits payable at foreign branches of American banks represent a money-gathering mechanism whose proceeds, like any other liability, can be invested in assets which can lead to problems when they depreciate in value. However, they entirely escape the deposit insurance premium.

These foreign deposits, when coupled with the other off-balance sheet liabilities such as standby letters of credit, interest rate swaps, and loan sales recourse, pose tremendous systemic risks which should be factored into the assessment premium schedule.

In conclusion, we thank you for providing the Independent Bankers Association of America a chance to participate in these hearings. We look forward to working with the Committee in fashioning deposit insurance reform which treats all institutions and depositors fairly, encourages the greatest possible degree of market discipline, and avoids excessive government regulation.

Thank you.

TESTIMONY OF

B. F. (Chip) Backlund
President

Independent Bankers Association of America

Hearings on Deposit
Insurance Reform

Before the

Committee on Banking, Housing and Urban Affairs

United States Senate

Honorable Jake Garn, Chairman

534 Dirksen Senate Office Bldg.

Washington, D.C.

September 10, 1985

Mr. Chairman and members of the Committee. My name is B.F. (Chip) Backlund and I am president of the Independent Bankers Association of America (IBAA), a national trade association representing 7,500 commercial banks throughout the nation. I also serve as president of the Bartonville Bank, a $36 million bank near Peoria, Illinois.

I appreciate the opportunity to participate in this morning's hearings. The Committee is to be commended for recognizing the need for deposit insurance reform. In my opinion, these hearings are long overdue.

Mr. Chairman, it would not be an overstatement to say that deposit insurance is the rock upon which this nation's entire financial system is built. Since the Great Depression, the FDIC shield has served as an enduring emblem of confidence that every bank depositor recognizes and depends upon. It has stood for the simple proposition that in the event of a bank failure, all depositors will be fully protected up to $100,000 on their deposits. For 50 years, this system has worked extremely well, even under the recent strain of a record number of bank failures.

As we all know, the FDIC today is facing an exceptional strain in the form of at least 100 bank failures anticipated by year's end. While we are fully confident that the FDIC fund is healthy and will continue to be able to withstand any bank failure in the foreseeable future, it is appropriate that Congress should take time to reexamine the Federal Deposit Insurance Act and to take steps to strengthen it and render it more efficient and equitable for all bank depositors.

While I understand that these hearings will also address issues related to the FSLIC fund and problems in the thrift industry, we should be most careful to maintain the independence of these two funds. The IBAA recognizes and strongly supports maintaining the unique character of the savings and loan industry in meeting this country's housing needs. As long as fundamental functional differences exist between commercial banks and thrift institutions, the insurance needs and capabilities of the two industries will differ. In our view, a merger of the FDIC and FSLIC funds would be harmful to both industries and to the public.

Because deposit insurance is the foundation of our modern banking system, it is difficult to speak of deposit insurance reform without addressing some of the most basic questions about our financial system. Who should be protected by deposit insurance--all depositors or just small ones? When and how should a bank be permitted to "fail"? How much risk should the FDIC bear-- and how much discipline should the market provide?

We understand that these hearings will cover an extremely broad range of issues--and they should. However, this morning, I would like to limit my remarks to two key areas:

1) What is the proper role of the federal deposit insurance fund?

2) What actions can and should the FDIC take to limit its own liability and to instill greater market discipline among commercial banks?

The first of these issues is easily the most important and also the toughest. In order to deal with it, let's go back to the beginning--to passage of the original Banking Act of 1933--and re-examine certain basic principles in the existing deposit insurance system.

What are those principles?

First and foremost, deposit insurance was created out of the trauma of the Depression. Its central principle was--and continues to be--that deposit insurance should provide a floor of minimal, federally guaranteed, protection for every depositor of an FDIC-insured institution, up to a certain limit. Congress has set this amount at $100,000 per customer. This ceiling--a "safety net", if you will--has worked well in maintaining customer confidence and preventing "runs" on financial institutions. Depositors have come to know and rely upon this $100,000 limit, and it should be retained.

Second, the FDIC was created by Congress to assist in the orderly closing of federally insured banks that fail and to assure that these closings are handled in a fair and efficient manner. It was not designed to protect banks from the possibility of failure. As the Senate Report to the original 1933 Act states:

> ....The great number of banks now in the hands of receivers has created a situation in which a very large number of persons are unable to meet their obligations and in which many business houses are embarrassed through inability to get the use of their funds.....In order to provide against a repetition of the present painful experience in which a vast sum of assets and purchasing power is 'tied-up', we have recommended the creation of a Federal bank-deposit insurance Corporation to liquidate the assets of closed member banks.....to insure the time and demand deposits of such banks.....

(S. Rep. No. 73-77,73rd Cong., 1st Sess.11 (1983)).

In other words, the FDIC was designed to promote the stability of the banking system and to prevent depositors' funds from being "tied-up" indefinitely. The FDIC, as receiver for failed banks, should act to protect the small depositor. The fund was never designed to protect all depositors or to prevent banks from failing.

It is this second principle-the limited nature of federal deposit insurance-that has been seriously eroded during the past several years.

Within the past 18 months, we have witnessed the development of a de facto two-tiered banking system, in which one of the nation's largest banks, Continental Illinois, "failed", yet none of its uninsured depositors lost any of their deposits. During this same period, more than 20 smaller FDIC-insured banks failed, in which uninsured depositors lost significant amounts of their deposits, either through straight liquidation or what the FDIC termed a "modified payout" experiment. Under this procedure, the failed banks were acquired by other institutions through a transfer of insured deposits, but uninsured depositors were treated the same as if the banks had been liquidated. (A chart of these failures is attached as Appendix A.)

To put it succinctly, the element of fairness is rapidly disappearing from our deposit insurance system. As the former Comptroller of the Currency, C. Todd Conover, admitted last year at the Continental hearings, we have now reached the point in this country where some banks are "too big to fail". The reverse of this is also true, as demonstrated by the use of the modified payout in smaller-sized banks; many community banks are "too small to save." We did not hear any talk of "modified payouts" or "market discipline" when Continental failed. In fact, such options were never even considered. As the FDIC's 1984 Annual Report stated, "Permitting Continental to fail and paying off insured depositors was never a feasible option for the regulators."

It is hard to overstate the long-range significance of this new system. On the one hand, the federal government has, in effect, announced that it will not only fully insure all deposits at the nation's largest money center banks, but these banks' other general creditors as well--a tremendous obligation by anyone's standards. On the other hand, the "modified payout" experiment demonstrates that the concept of market discipline, so cherished by the FDIC, is only being applied to institutions too small to save. Where is the market discipline for the Continental-sized banks?

Until recently, most bank failures have been handled through 1) FDIC-assisted mergers, 2) purchase and assumptions, or 3) straight liquidations. In the case of mergers, the acquiring institution acquires all deposits of the failed bank and therefore all uninsured depositors are made whole. In purchase and assumptions, the acquiring bank purchases the assets and assumes the liabilities of the failed bank, often with FDIC assistance, but all uninsured depositors are still made whole. In liquidations, on the other hand, all insured depositors are immediately paid off by the FDIC and the uninsured depositors stand in line with all other unsecured creditors and recover whatever monies the FDIC is able to collect over the several years needed to liquidate the bank.

A fourth alternative was initiated on July 8, 1983, with the failure of the Union National Bank of Chicago. The FDIC began a procedure called a "modified payout" or "deposit transfer," which is a hybrid between a P&A and a liquidation. In the Union National Bank, the FDIC transferred all insured deposits to the acquiring bank, Seaway National Bank of Chicago, but did not transfer the $1.5 million in uninsured deposits. In effect, this put uninsured depositors in the same position as if the bank had been liquidated. (In some cases, the FDIC has cushioned this loss by making an "advance payment" to depositors for that portion of the uninsured deposits which the agency expects to recover eventually, rather than making them wait, as in a straight liquidation.)

Contrast this situation with what happened last year at Continental. In that case, a liquidation was clearly impossible, since the approximately $25-35 million in uninsured deposits far outweighed the $4 million in insured deposits. However, rather than using some form of modified payout as in other recent bank failures, the FDIC, in effect, became the conservator of the bank and made all creditors whole, including uninsured depositors. The FDIC, meanwhile, will undoubtedly suffer substantial losses which may well exceed the cost that would have been incurred through some form of modified payout.

It is not hard to see the kind of impact that Continental is having on the marketplace. Let me ask you: If you were a depositor today and wanted to make a large deposit (e.g. $300,000) in a safe place, where would you be more likely to go--a bank the size of Continental Illinois or one the size of Union National? Most likely, you would go where you would get 100% insurance coverage--i.e. Continental Illnois. How can we say that it is fair for one uninsured depositor to be made whole and another one not? On whom should the risk of failure fall--the Chicago depositor who puts his money in Union National or the Japanese depositor who wires his deposit to Continental? Why should only the small banks face the risk of failure?

Please do not misinterpret my remarks as suggesting that I am opposed to the action that was taken by the FDIC to save Continental or, conversely, that the FDIC should guarantee all uninsured depositors of small banks. What I am saying, to the contrary, is that all uninsured depositors over the

$100,000 limit should be treated similarly, if not equally. We must re-shape the FDIC so that depositors over the $100,000 threshold in the large bank failure situations will always suffer some degree of loss.

Even the FDIC, I think, recognizes that the fairness issue is real and serious. Chairman Isaac of the FDIC testified before this Committee on July 23, that Congress should address this fairness question directly. According to Isaac,

> .... There is the question of how bank failures can be handled so as not to discriminate or give the appearance of discriminating against smaller banks.... To remove the uncertainty regarding the distribution of uninsured depositors, for example, Congress could provide that a fixed minimum percentage be paid -- say 80 to 90 percent of funds over the $100,000 limit. A number of variations on this theme are possible.

Congress, he said, should consider building upon the agency's experience with the modified payout experiment in smaller banks. We support Mr. Isaac's proposal and contend that it is needed in order to prevent the perversion of our deposit insurance system into a welfare program for the country's largest banks.

The idea of extending the modified payout to large bank failures has also been discussed by the Working Group of the Cabinet Council on Economic Affairs in its report on deposit insurance reform issued in January 1985. The report stated:

> Prospective advantages of this proposal include the potential for increasing creditor discipline and the fact that loss sharing would permit a large bank or thrift to be merged with less cost to the insurance corporation. In addition, consistent use of the 'haircut' approach would eliminate the inequity of the status quo wherein large institutions are afforded de facto 100 percent coverage for uninsured creditors because a liquidation is not deemed feasible, while only the uninsured creditors of smaller insitutions are subject to a liquidation and potential loss.

(Report, pp 47-48. For the IBAA's comments on the Working Group's study, see Appendix B.)

In our opinion, the Working Group raised an extremely important point by talking about the cost savings inherent in these "haircuts", but then shied away from taking a position on whether such a procedure would be cost-effective. We think it would be.

We recognize that this is not an easy problem to solve. Our bank regulators need to take very seriously the ruinous impact that money center bank failures could have on the nation's payment system and our economy--including smaller banks and thrifts. Although the IBAA does not have a comprehensive solution to the "too big to fail" problem at this time, I would like to offer the following suggestions to the Committee:

First - That the $100,000 coverage limit for all depositors is basically sound and should be retained.

Second - That the basic concept behind the "modified payout"--i.e., that large depositors over $100,000 should bear *some* degree of market risk in all failures--is essentially fair and workable, provided that it is applied to *all* bank failures, both large and small, and to *de facto* failures like Continental. *I suggest that this Committee formally request the FDIC to provide it with a set of legislative and regulatory alternatives for extending the modified payout concept to all bank failures*. Until such time as this "experiment" applies across-the-board, it should be terminated.

Third - That a system of risk-based insurance premiums be instituted, consisting of two components.

The first component would be correlated to a bank's unique financial condition, as established by a rating system similar to the present CAMEL rating system. The second component would be based upon the *systemic* risk that a bank poses for the deposit insurance fund as a whole. This factor would be measured by the potential draw that a bank could make upon the fund's resources in the event of the bank's failure. In short, the bigger the risk that an institution poses to the fund's resources, the higher its premiums should be.

Such a systemic approach would necessarily include assessments based upon foreign, as well as domestic, deposits. As FDIC Director Irvine H. Sprague stated recently in an excellent speech on this issue:

> While the assessment rate has been essentially unchanged in statutory amount since our beginning over 50 years ago, the total liabilities and funds generation apparatus of banks have undergone significant change. One example: deposits payable at foreign branches of American banks represent a money-gathering mechanism whose proceeds, like any other liability, can be invested in assets which can lead to problems when they depreciate in value. However, they entirely escape the deposit insurance premium.
>
> For example, BofA paid us almost $40 million in assessents in 1984, whereas Citibank paid $18.5 million. Both, in my opinion, enjoy de facto 100 percent insurance protection, but BofA, with less total book liabilities, paid more than twice as much in insurance assessments. Neither paid in proportion to the assessments on smaller banks which rely completely on domestic deposits. (emphasis added)

These foreign deposits, when coupled with the other off-balance-sheet liabilities such as standby letters of credit, interest rate swaps, and loan sales recourse, pose tremendous systemic risks which should be factored into the assessment premium schedule. By varying rates through the use of these two components, insurance premiums for individual banks would be adjusted in accordance with both their unique financial condition and the size and range of banking activities in which they engage.

Mr. Chairman, a great deal of the testimony at these hearings has been devoted to risk-based insurance premiums; they have been the centerpiece of both the FDIC's and the FSLIC's reform proposals. While the IBAA supports the concept of risk-based premiums and would support efforts by the regulators to develop measures of risk which are equitable, I do not think that such a change is going to instill a significant degree of market discipline or is going to be a panacea to restore the soundness and integrity of the insurance funds. Congress' first priority should be to perfect the funds against the virtually unlimited liability posed by large bank failures and to restore a sense of fairness to the treatment of all depositors.

Fourth - In making these various reforms, Congress should address the politics and management of the Federal bank regulatory agencies. For example, the FDIC Board should be enlarged and depoliticized, so that it better represents the interests of the banks that are currently being treated as "too small to save." We recommend that the Board be expanded to at least five members and should consist of individuals who have "hands-on" banking experience. At least one director should have a banking background which enables him or her to understand and empathize with the nation's small community banks. This would provide a wider range of banking experience within the Board's membership.

The terms of directors should be staggered and of sufficient length to provide continuity and less political involvement. The appointment in recent years of "cheerleaders" for the Administration has proved generally disruptive to our financial system. Banking laws should be changed by Congress, not by appointed bank regulators. Along these same lines, we also feel strongly that the Office of the Comptroller of the Currency should be removed from the Treasury Department and should be made accountable to a board of directors, in the same manner as the other banking agencies.

My personal contention is that a major contributing cause of the current problems in the insured finanical system is the failure of the regulators to adequately police problem institutions and to anticipate future problems and risks. On the other hand, the four steps outlined here would enhance consumer confidence by strengthening the fund financially, promoting greater market discipline for all banks, and bringing more even-handed management to the fund.

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The second area I would like to discuss this morning is the FDIC's recent efforts to limit its potential insurance losses through regulation. In general, the IBAA supports and recognizes the FDIC's need to protect itself against undue risks but prefers to see this done in a way that does not unfairly discriminate against smaller institutions and does not unduly limit the legitimate investment activities of well-managed, healthy banks.

The FDIC's main regulating effort to reduce losses and instill greater market discipline has involved brokered deposits. The FDIC last year issued a regulation limiting deposit insurance for all deposits placed by or through brokers to $100,000 per broker, per insured institution. This regulation currently is being challenged in the courts.

In general, the IBAA has supported Chairman Isaac in his effort to limit the indiscriminate access by banks to "hot money" by denying deposit insurance for such funds. We do not believe that these deposits--which are essentially large CDs broken up into $100,000 chunks--are entitled to the protections designed for small depositors. In addition, we have supported the FDIC's monthly reporting requirements, by which banks with brokered deposits in excess of the bank's total capital or five percent of the bank's total deposits must file monthly reports with the FDIC.

Unfortunately, several of the agencies' other proposals to instill market discipline through regulation would be far less effective and would have a harmful effect on well-run institutions. First, the FDIC has proposed that all banks be required to maintain total capital of nine percent, with up to three percent allowed in the form of subordinated debt. This compares to the existing 5 1/2 percent primary and 6 percent total capital requirements.

While we support the idea that all insured banks should maintain healthy levels of capital, the issue of subordinated debt poses serious problems for many of this country's smaller commercial and agricultural banks. Subordinated debt is simply not a viable vehicle for community banks, because little, if any, market exists for such debt issuances and the costs associated with public issuance of these debt instruments are too high. Therefore, small banks would be compelled to seek equity capital to meet the 9% level, a far more difficult proposition for most institutions. Because the money center banks have a significantly greater ability to raise subordinated debt than do smaller institutions, this regulation would place community banks at a serious competitive disadvantage.

In addition, a flat 9% rule is too simplistic. Acting Comptroller of the Currency Joe Selby noted recently--quite correctly--that an across-the-board net capital requirement may not make good economic sense. He indicated that his office is considering a more sophisticated "risk asset approach" which would take a number of risk factors into account, including off-balance sheet activity. The IBAA strongly recommends that the regulators thoroughly consider such a broader-based approach before moving ahead with these capital requirements.

Likewise, we are tremendously disturbed by the FDIC's proposal to require increased disclosure of financial information and enforcement actions taken against banks by the FDIC. While such a measure theoretically sounds as though it would instill greater market discipline, these proposed rules would harm both poorly managed and well managed institutions.

First of all, it is well known that smaller institutions are more often the target of formal regulatory action, simply due to their size and lesser capacity to defend themselves legally against the government. Such a regulation would result in the false public perception that smaller institutions are somehow less safe than larger ones. Second, the financial information currently available to the public is sufficient for most investors to evaluate a bank's condition and to place their money accordingly. Third, more disclosure across-the-board will likely encourage runs on smaller institutions which are without the resources to withstand them. Fourth, such action by the FDIC discriminates against state nonmember banks since the OCC and the Federal Reserve are not requiring the same degree of disclosure by banks under their supervision.

The bottom line is that it is very difficult and often counterproductive for the FDIC to attempt to limit its insurance liability through blanket regulations which impose restrictions on, or compel disclosure by, all institutions. Many of the problems which the FDIC is attempting to solve can be better addressed through improved bank examination, better supervision of problem banks, and stronger enforcement action, rather than through burdensome across-the-board regulation.

In conclusion, we thank you for providing the Independent Bankers Association of America a chance to participate in these hearings. We look forward to working with the Committee in fashioning deposit insurance reform which treats all institutions and depositors fairly, encourages the greatest possible degree of market discipline, and avoids excessive government regulation.

Thank you.

APPENDIX A

BANK FAILURES WITH "MODIFIED PAYOUTS" TRANSFER OF INSURED DEPOSITS 1983-1985

	Name and Location of Failed Bank	Date of Failure	Deposit Size	Uninsured Deposits Not Transferred to Acquiring Bank	% Advanced by FDIC on Uninsured Deposits	Net Potential Loss to Depositors
1.	Union National Bank of Chicago, Chicago, IL	July 8, 1983	$23.5M	$1,500,000	0	$ 1,500,000
2.	Atkinson Trust & Savings Bank, Atkinson, IL	November 22, 1983	$18.6M	$ 65,000	0	$ 65,000
3.	Indian Springs State Bank, Indian Springs, KS	January 27, 1984	$25.7 M	$800,000	0	$ 800,000
4.	Seminole State National Bank, Seminole, TX	March 16, 1984	$41.3 M	$705,000	55%	$ 387,750
5.	Security National Bank of of Lubbock, Lubbock, TX	April 13, 1984	$40.6 M	$1,100,000	40%	$ 440,000
6.	Gamaliel Bank, Gamaliel, KY	April 18, 1984	$21.6 M	$338,000	55%	$ 338,000
7.	United American Bank, Chicago, IL	April 26, 1984	$29 M	$2,000,000	60%	$ 1,200,000
8.	First National Bank, Snyder, TX	May 4, 1984	$15.2 M	$347,000	40%	$ 138,800
9.	National Bank of Carmel, Carmel-by-the-Sea, CA	May 8, 1984	$70.8 M	$4,600,000	60%	$ 2,760,000
10.	First Continental Bank & Trust Co. of Del City, Del City, OK	May 11, 1984	$92.3 M	$2,300,000	40%	$ 920,000
11.	Republic Bank of Kansas City, Kansas City, MO	June 18, 1984	$37 M	$747,000	0	$ 747,000
12.	American Bank, St. Joseph, TN	June 27, 1984	$30 M	$727,000	0	$ 727,000
13.	Dayton Bank & Trust Co., Dayton, TN	November 30, 1984	$45.2 M	$482,000	75%	$ 361,500
14.	Uehling State Bank, Uehling, NE	December 18, 1984	$3.3 M	$ 437,000	0	$ 437,000

BANK FAILURES WITH "MODIFIED PAYOUTS" TRANSFER OF INSURED DEPOSITS 1983-1985

	Name and Location of Failed Bank	Date of Failure	Deposit Size	Uninsured Deposits Not Transferred to Acquiring Bank	% Advanced by FDIC on Uninsured Deposits	Net Potential Loss to Depositors
15.	Peoples Bank & Trust Co., Wartburg, TN	February 8, 1985	$19.8 M	$234,000	0	$ 234,000
16.	Citizens State Bank, Fulda, MN	February 15, 1985	$34.7 M	$331,000	0	$ 331,000
17.	First Trust Bank of Lakefield, Lakefield, MN	May 31, 1985	$20.4 M	$197,000	0	$ 197,000
18.	Strongs Bank, Dodgeville, WI	June 14, 1985	$30.8 M	$2,688,000	0	$ 2,688,000
9.	Golden Pacific National Bank, New York, NY	June 21, 1985	$157.1 M	$9,000,000	0	$ 9,000,000
20.	Park West Bank, N.A. Farmers Branch, TX	August 15, 1985	$16.9 M	$5,500,000	50%	$ 2,750,000

President
A.J. (JACK) KING, President
Valley Bank of Kalispell
Kalispell, Montana 59901

First Vice President
B.F. (CHIP) BACKLUND, President
Bartonville Bank
Bartonville, Illinois 61607

Second
CHARLES T (C
Gulf N.
Texas City, Texas 77590

APPENDIX B

Castile, New York 14427

Independent
BANKERS ASSOCIATION OF AMERICA

WASHINGTON
OFFICE

1625 MASSACHUSETTS AVENUE N.W. · SUITE 202, WASHINGTON, D.C. 20036 202/332-8980

November 30, 1984

Honorable Donald T. Regan
Cabinet Council on Economic Affairs
Department of the Treasury
15th & Pennsylvania Ave., NW
Washington, D.C. 20220

Dear Mr. Secretary:

The Cabinet Council's review of our system of deposit insurance is most timely. The issue of the safety and soundness of the banking system and in turn, its deposits, is very much on the minds of the American consumer and American business. The near failure of Continental Illinois and the unprecedented announcement of the FDIC on May 17 that "all depositors and general creditors of the bank will be fully protected" underlined the problems and inequities of the present system.

We agree wholeheartedly with your comments before the U.S. League that insured institutions should not make bad loans on the assumption that the government will bail them out. It is not community banks that have been the beneficiary of government assistance. If an actuarially sound system financed by depositors is vastly preferable to a system carried by taxpayers' subsidies, as you stated, then large banks must be made to pay into the insurance system an amount which fairly represents the risk they place on the entire system and the disproportionate claims they are likely to make on the insurance fund in the event that they require assistance.

Knowing that the Cabinet Council on deposit insurance reform is developing its recommendations, the IBAA's special committee on deposit insurance reform met recently to develop our recommendations for the Council's consideration. We have briefed Assistant Secretary Thomas Healey on our deliberations and appreciate this courtesy. Attached is the list of resolutions adopted by our committee which set forth our policy recommendations. Our committee is still reviewing the issue of the appropriate level of capital for banks, including what percentage of capital could be subordinated debt. We do feel very strongly that thrifts, which have almost all the powers of commercial banks, must have their capital requirements phased up to commercial bank levels.

Also enclosed for your consideration is our recent comment letter to the FDIC regarding increased disclosure of financial information.

The IBAA stands ready to assist the Cabinet Council in any way as it seeks to design an insurance system that is both equitable and actuarially sound and which meets the public purposes for which it was originally designed.

Sincerely,

A. J. King

A. J. King
President

Enclosure

RESOLUTIONS OF THE IBAA FEDERAL LEGISLATION COMMITTEE'S SUBCOMMITTEE ON DEPOSIT INSURANCE REFORM, NOV. 15, 1984:

The IBAA fiscally and philosophically opposes 100% insurance coverage of deposits. But recognizing the current reality, as long as 100% coverage exists for large banks it should be extended immediately to all banks.

A more rational and equitable deposit insurance system should comprise the following elements:

1) We strongly support maintaining the current $100,000 level of deposit coverage. This level of coverage is essential to maintain confidence in the banking system.

2) The IBAA supports tying rebates of the insurance assessments to a bank's riskiness, as proposed by the FDIC in its report to Congress. Riskiness would be correlated with a bank's CAMEL rating, especially its exposure to interest rate and credit risk. But those elements of the CAMEL rating which are subjective, particularly loan classifications and management, should be weighted less heavily than more objective factors. Domestic and foreign loans must be accorded the same treatment. And a method for appealing a bank's CAMEL rating must be established.

We recommend a greater differential between banks in different risk categories than the FDIC has proposed. The IBAA would support an increase in the assessment rate if that is necessary in accordance with actuarial soundness. If assessments of the current rate of 1/12 of a percent are insufficient to allow rebates, we would support variable rate premiums based on risk on the front end.

In addition to assessing a bank's individual risk, banks should be assessed a separate charge according to the systemic risk they pose for the deposit insurance fund and the U.S. Treasury. This risk should be measured by the draw a bank might make upon insurance fund resources in the event of a failure or rescue.

3) The IBAA supports assesaments on foreign deposits at a level equal to that on domestic deposits.

4) The IBAA supports the removal of insurance on the deposits of federal government agencies and on all brokered state and local deposits. We do not support removal of insurance on state and local government deposits or deposits placed directly by financial institutions as contrasted with the removal of such insurance from brokered deposits.

5) If the FDIC is forced to pay off in the event of failure, the modified payoff approach is the best system for doing so.

6) The FDIC should act as insurer only. The Federal Reserve should serve as lender of last resort and source of liquidity for banks.

7) The IBAA feels that the FDIC should have the authority to examine any institution that it insures.

8) Thrifts which now are empowered to take demand deposits and make commercial loans should have the same capital requirements as commercial banks and this parity in capital should be phased in over a six year period. Thrifts should not be allowed to expand their activities until such time as they reach capital levels equal to commercial banks.

Use of the name "Bank" should be disallowed for any financial institution that does not meet the minimum capital requirements of FDIC insured commercial banks or any other requirements made by a bank regulatory authority.

9) The Board of Directors of the FDIC should be expanded to insure broad industry representation.

# # # # # #

Chairman ST GERMAIN. Mr. Cairns, how do you personally feel about the insurance of foreign deposits?

Mr. CAIRNS. The insurance on—well, I have some—you are talking about the foreign deposits of large banks?

Chairman ST GERMAIN. Well, foreign deposits in the banks that are operating overseas. Right now they are exempt.

Mr. CAIRNS. They are exempt, and the question that comes to my mind immediately when that subject comes up——

Chairman ST GERMAIN. Now, I am asking Jim Cairns. I am not asking the president of the ABA.

Mr. CAIRNS. I am giving you an answer that would be the same either way, Mr. Chairman.

Chairman ST GERMAIN. All right.

Mr. CAIRNS. The question that comes to my mind immediately is should the FDIC insure foreign deposits and what exposure and problems does that bring? If there was an assessment for the insurance premium, then those deposits are insured.

Chairman ST GERMAIN. That is right.

Mr. CAIRNS. That brings in the whole question of political risk in foreign countries, the foreign exchange rates, and a whole complexity of issues that frankly I don't have the answers to. I think it is a very big problem.

It seems to me having those deposits uninsured might reduce the exposure to the FDIC and I don't think impairs the safety and soundness of our industry. So offhand, without an awful lot of answers, I say I have to be very concerned and against it.

Chairman ST GERMAIN. We will discuss that a little further during the question-and-answer period.

Mr. CAIRNS. May I answer one other question you asked a moment ago, I think, of me? And that had to do with the regulatory examiners and what could be done there to stabilize that.

I think that is a terribly important question in light of the difficulties that we have seen, and I have two suggestions.

First, I think some real effort should be made on the part of the regulatory agencies to use more modern techniques of examination. Computer-based techniques are widely used in the industry today and they are not widely used in the regulatory agencies.

And, second, and you mentioned it yourself, competitive salaries and benefits and some stabilization of the time they are away from home. I think these people have been through just a torture in the last few years, as they have had to spend weeks and months away from their families because of the situations that they have been involved in, and I think some real effort should be made to stabilize where they are, make sure they are home more often and pay them appropriately, and I think along with training would stabilize that, and to me it is one of the most critical and important things we could do.

But it does take money, and it takes legislation to do that.

Chairman St Germain. We are going to submit questions to——

Mr. Roth. Mr. Chairman, I wonder, could I ask one quick question?

Chairman St Germain. Not right now. We are going to ask all of the members of the panel to give us an outline on this, suggestions, and so forth.

Mr. Cairns. Be happy to do it. Thank you.

Chairman St Germain. We will submit that in writing and ask you to answer in writing so that you have more time to do it.

Mr. Cairns. Thank you.

Chairman St Germain. Our next witness is William S. Edgerly appearing on behalf of the Association of Reserve City Bankers.

STATEMENT OF WILLIAM S. EDGERLY, CHAIRMAN, STATE STREET BANK & TRUST CO., BOSTON, MA, ON BEHALF OF THE ASSOCIATION OF RESERVE CITY BANKERS

Mr. Edgerly. Thank you, Mr. Chairman.

I am William Edgerly, chairman of State Street Bank & Trust Co., Boston, MA, as you point out, representing the Association of Reserve City Bankers.

The association has taken a leading role in dealing with the issue of risk. It was actively involved in developing a self-regulatory system for managing risk on large dollar wire transfer systems recently adopted by the Federal Reserve Board.

Last January the association formed a task force to review the issues of deposit insurance and capital adequacy. The task force has taken an approach that it believes would strike a satisfactory balance between free competition, protection of small depositors, and stability of the financial system. Under this broad approach, it focused on several themes which will be submitted as recommendations for consideration by the association.

One theme is whether capital requirements should be based on risk, the idea being that banks with higher risks should have relatively higher capital requirements.

A second deals with the appropriate extent of protection for uninsured depositors and related questions concerning the basis for assessment of insurance premiums.

The third concerns the appropriateness of risk-based deposit insurance premiums as compared with risk-based capital requirements.

Fourth is the question whether regulators should publicly rate the financial condition of banks and the issue of timing for the regulators to address solvency problems at troubled institutions.

Finally, the task force has examined whether banks should have a greater voice in the management of the deposit insurance system.

Later this month, the association will review the task force's recommendations. The association would like to communicate to the members of the subcommittee its conclusions concerning these matters and would welcome the opportunity to work with you in addressing these issues during the period ahead.

I would like to turn now to the subcommittee's questions concerning the need for changes in the existing system of regulation and supervision.

Our association wishes to draw attention to a weakness in the existing system and propose a solution for it which we believe can be implemented now. This is a matter which has not yet received the attention it deserves.

At present, the FDIC insurance fund and the Federal Reserve System can be put at risk by firms which are entirely unregulated as a result of these firms using affiliated depository institutions to process their payments. Let me explain how this situation arises.

The cornerstone of the payments system is FedWire, an electronic communications and settlement system of the 12 Federal Reserve Banks, which handles over $360 billion in transactions daily. Any depository institution, as defined by section 19(b) of the Federal Reserve Act, whether a bank or a thrift and whether or not federally insured, has direct access to this wire system.

Users of FedWire constantly make and receive sizable payments, and at any particular moment a user's account may be overdrawn as a result of sends exceeding receives. The Federal Reserve gives irreversible credits to receivers of FedWire, so that if a sender failed to cover its overdraft, the regulatory system would be at risk.

The Fed might respond to the situation by making a secured loan to the overdrafted institution. If at some later time the institution failed, the Fed would have a prior claim to the assets securing the loan, thus leaving fewer assets and less value for the FDIC.

The general point is that the FDIC and the Federal Reserve System may be put at risk by the failure of a bank to meet its payments system obligations. This risk can be controlled through the normal regulatory process by limiting the permissible activities of banks and their holding companies and by examining, monitoring, and controling capital adequacy riskiness of assets and liabilities, and operating procedures.

The problem is that holding companies engaged in a wide variety of businesses can own banks but remain entirely outside the regulatory system.

If a holding company processes payments through its affiliated bank on an overdraft basis; that is, makes payments which cause its account to go into an overdraft condition, which in turn may cause the bank to overdraft its Fed account, the failure of the holding company to pay the bank may make it impossible for the bank to pay the Fed, thus triggering a chain of settlement failures.

Unless holding company risks are controlled through the supervisory process, an affiliated bank can expose the Fed and the FDIC to whatever uncontrolled risks are inherent in its parent's unregulated business, since the bank may not make an independent credit judgment about the parent's creditworthiness.

Due to the narrowness of the bank definition in the Bank Holding Company Act and the lack of controls on the activities of unitary savings and loan holding companies under the National Housing Act, unregulated companies can own depository institutions which can be used to process payments, thus exposing the FDIC to risk.

Chairman ST GERMAIN. You are talking about nonbank banks?

Mr. EDGERLY. Yes, essentially that.

The way to deal with this problem is to prevent an unregulated holding company from using an affiliated depository institution to process its payments. This would shield the system from exposure to holding companies that are not regulated and supervise for safety and soundness.

At the same time, such holding companies and their affiliates would be free to access the payments system indirectly and their owned depository institutions would be free to offer the full range of services, including payments for customers provided by competing depository institutions.

Action on this matter is clearly needed and could be taken by the subcommittee without waiting for a total reform package.

With the permission of the subcommittee, I would like to submit a draft of proposed legislation to address this problem and a more detailed statement of our views as attachments to this testimony.

Chairman ST GERMAIN. That would be deeply appreciated.

Mr. EDGERLY. Thank you.

Chairman ST GERMAIN. Have you completed your verbal presentation?

Mr. EDGERLY. Yes, I have.

[The prepared statement of Mr. Edgerly with attached draft of proposed legislation, and a statement regarding, "Risk to the Payments System From Unregulated Holding Companies," follow:]

STATEMENT OF WILLIAM S. EDGERLY
CHAIRMAN, STATE STREET BANK AND TRUST COMPANY
ON BEHALF OF THE ASSOCIATION OF RESERVE CITY BANKERS
BEFORE THE
SUBCOMMITTEE OF FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
OCTOBER 3, 1985

Mr. Chairman and members of the Subcommittee, I am William S. Edgerly, Chairman of State Street Bank and Trust Company, Boston, Massachusetts. I am appearing before the Subcommittee today on behalf of the Association of Reserve City Bankers, an association of 400 banking executives from 150 of the nation's major banking institutions. The Association has taken a leading role in dealing with the issue of risk. The two most recent publications of the Association in this area are *Risks in the Electronic Payments Systems* and *The Final Report of the Risk Control Task Force*. The latter publication formed the basis of a self-regulatory system for managing risk on large dollar wire transfer systems recently adopted by the Federal Reserve Board.

The Association appreciates this opportunity to present testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. The issues being addressed by this Subcommittee are important to the future of the nation's financial system and its ability to continue meeting the financial needs of the public.

Last January the Association formed a Task Force to review the issues of deposit insurance and capital adequacy. The Task Force has taken an approach that it believes would strike a satisfactory balance between free competition, protection of small depositors and stability of the financial system. Under this broad approach, it focussed on several themes which will be submitted as recommendations for consideration by the Association.

One theme is whether capital requirements should be based on risk, the idea being that banks with higher risks should have relatively higher capital requirements. A second deals with the appropriate extent of protection for uninsured depositors and related questions concerning the basis for assessment of insurance premiums. The third concerns the appropriateness of risk based deposit insurance premiums as compared with risk based capital requirements. Fourth, is the question whether regulators should publicly rate the financial condition of banks and the issue of timing for the regulators to address solvency problems at troubled institutions. Finally, the Task Force has examined whether banks should have a greater voice in the management of the deposit insurance system.

Later this month the Association will review the Task Force's recommendations. The Association would like to communicate to the members of the Subcommittee its conclusions concerning these matters and would welcome the opportunity to work with you in addressing these issues during the period ahead.

I would like to turn now to the Subcommittee's questions concerning the need for changes in the existing system of regulation and supervision. Our Association wishes to draw attention to a weakness in the existing system and propose a solution for it which, we believe, can be implemented now. At present the FDIC insurance fund and the Federal Reserve System can be put at risk by firms which are entirely unregulated as a result of these firms using affiliated depository institutions to process their payments. Let me explain how this situation arises.

The cornerstone of the payments system is FedWire, an electronic communication and settlement system of the 12 Federal Reserve Banks, which handles over $360 billion in transactions daily. Any "depository institution" as defined by section 19(b) of the Federal Reserve Act, whether a bank or thrift, and whether or not federally insured, has direct access to this wire system.

Users of FedWire constantly make and receive sizeable payments, and at any particular moment a user's account may be overdrawn, as a result of sends exceeding receives. The Federal Reserve gives irreversible credits to receivers of FedWires so that if a sender failed to cover its overdraft, because of lack of liquidity or insolvency, the regulatory system would be at risk. The Fed might respond to the situation by making a secured loan to the overdrafted institution. If at some later time the institution failed, the Fed would have a prior claim to the assets securing the loan, thus leaving fewer assets and less value for FDIC.

Large dollar payments may also be made over private systems, the most important of which is CHIPS (Clearing House Interbank Payment System). CHIPS is owned and operated by the New York Clearing House and handles over $300 billion per day on behalf of 141 participant banks. CHIPS transfers are settled on a net basis at the end of the day through accounts at the New York Federal Reserve Bank. If a bank failed to settle, other banks expecting payments might themselves be unable to settle, and the New York Federal Reserve Bank might well extend secured credit to the failing bank to avoid a chain reaction of bank failures. Again, if at some later time the bank failed, the Fed's prior claim on assets would mean less value for the FDIC.

The general point is that the FDIC and the Federal Reserve System may be put at risk by the failure of a bank to meet its payment system obligations. This risk can be controlled through the normal regulatory process, by limiting the permissible activities of banks and their holding companies, and by examining, monitoring and controlling capital adequacy, riskiness of assets and liabilities, and operating procedures. The problem is that holding companies engaged in a wide variety of businesses can own banks but remain entirely outside the regulatory system.

If a holding company processes payments through its affiliated bank on an overdraft basis--that is makes payments which cause its account to go into an overdraft condition--which in turn may cause the bank to overdraft its Fed account, the failure of the holding company to pay the bank may make it impossible for the bank to pay the Fed, thus triggering the chain of events I previously described. Unless holding company risks are controlled through the supervisory process, an affiliated bank can expose the Fed and the FDIC to whatever uncontrolled risks are inherent in its parent's unregulated business, since the bank may not make an independent credit judgment about the parent's creditworthiness.

Due to the narrowness of the bank definition in the Bank Holding Company Act and the lack of controls on the activities of unitary savings and loan holding companies under the National Housing Act, unregulated companies can own depository institutions which can be used to process payments, thus exposing the FDIC to risk. While H.R. 20, as reported by this Subcommittee, would protect the FDIC from risk, by defining any bank insured by the FDIC as a "bank" under the Bank Holding Company Act, the prospects for enactment of H.R. 20 into public law are uncertain. Furthermore, state chartered banks eligible for but not insured by the FDIC, which have access to the payments system, would not be defined as banks by H.R. 20 and thus could continue to be owned by unregulated holding companies.

While FDIC would not be put at risk by the failure of such institutions to meet their payment obligations, the Federal Reserve System, and indirectly the American public, might well be put at risk if the Fed did not have adequate collateral to support a secured loan.

The way to deal with this problem is to prevent an unregulated holding company from using an affiliated depository institution to process its payments. This would shield the system from exposure to holding companies that are not regulated and supervised for safety and soundness. At the same time such holding companies and their affiliates would be free to access the payments system indirectly, and their owned depository institutions would be free to offer the full range of services, including payments for customers, provided by competing depository institutions. Action on this matter is clearly needed and could be taken by the Subcommittee without waiting for a total reform package. With the permission of the Subcommittee, I would like to submit a draft of proposed legislation to address this problem and a more detailed statement of our views as attachments to this testimony.

ATTACHMENT A

PROHIBITION ON PAYMENT ARRANGEMENTS

(1) No depository institution affiliate of an unregulated holding company may hold any demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties for, or process payments for or on behalf of, such holding company or any of such holding company's affiliates.

(2) For purposes of this section, the following definitions apply:

(a) the term 'depository institution' means any 'depository institution' as defined in Section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b));

(b) the term 'unregulated holding company' means any holding company which is not

(i) a 'bank holding company' within the meaning of Section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841); or

(ii) a savings and loan holding company engaged only in activities permissible for a multiple savings and loan holding company under Section 408(c) of the National Housing Act (12 U.S.C. 1730a(c));

(c) the term 'process payments' means any use of depository institution, Federal Reserve Bank, Federal Home Loan Bank Board or other similar accounts for the purpose of receiving or sending payments from one party to another party;

(d) the term 'affiliate' means any company that controls a depository institution and any subsidiary of such company. The terms control, subsidiary and company have the same meaning as in Sec. 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841).

ATTACHMENT B

RISK TO THE PAYMENTS SYSTEM FROM UNREGULATED HOLDING COMPANIES

1. The Payments System

For background, it is useful to begin with a brief description of the payments system. The payments system is the means by which funds are transferred between payers and receivers throughout the nation. It is of fundamental importance to the functioning of the economy.

The cornerstone of the system is FedWire, an electronic communication and settlement system of the 12 Federal Reserve Banks, which handles over $360 billion in transactions daily and whose volume is growing at a rate in excess of 10% annually. Since the enactment of the 1980 Financial Institutions Deregulation and Monetary Control Act, all "depository institutions," as defined by section 19(a) of the Federal Reserve Act, whether banks or thrifts and whether or not federally insured, have had direct access to the payments system as users of FedWire.

Users of FedWire are constantly making and receiving sizeable payments; at any moment a user's sends may exceed its receives from others, overdrawing the Federal Reserve account of the sender. Nonetheless, the Federal Reserve gives irreversible funds to receivers. If the sender failed to cover its overdraft, because of lack of liquidity or insolvency, the Federal Reserve, and indirectly the American public, would become a creditor of the failed sending institution.

Large dollar payments may also be made over private systems, the most important of which is CHIPS (Clearing House Interbank Payment System). CHIPS is owned and operated by the New York Clearinghouse Association and handles over $300 billion per day on behalf of 138 participant banks. On peak days total payments handled by FedWire and CHIPS have exceeded one trillion dollars.

CHIPS transfers are settled on a net basis at the end of the day through accounts at the New York Federal Reserve Bank. If a bank failed to settle, other banks expecting payments might themselves be unable to settle. While the New York Federal Reserve Bank would not be required to cover the system obligations of the failed bank, it might still do so to avoid an ensuing chain reaction of bank failures. Again, it would be the Federal Reserve, and indirectly the American public, which would be put at risk from a settlement failure.

The Federal Reserve Board is requesting participants in the payments system to adopt voluntary limits on FedWire overdrafts and on net obligations to other participants, so-called bilateral limits and net debit caps. Our Association worked closely with the Federal Reserve Board to develop these measures. While these measures reduce risk, they will not eliminate it. Their effectiveness requires rigorous new operating procedures, heightened awareness of creditworthiness on the part of all users of the payments system, and ongoing monitoring as part of the regulatory process.

Given the importance of the payments system to the economy and the risks associated with it, the safety and soundness of participants is essential. The way participant risk is controlled is through regulation. Regulatory agencies limit the permissible activities of depository institutions and their holding companies. They examine, monitor and control capital adequacy, the riskiness of assets and liabilities, and operating procedures. Transactions between holding companies and their depository institutions are examined, monitored and controlled. In these ways, regulation makes a crucial contribution to the stability of the payments system. The problem is that such regulation does not apply to certain holding companies.

2. Risks which Unregulated Holding Companies Pose for the Payments System

A hypothetical case may help to illustrate the risks which unregulated holding companies pose for the payments system. Suppose a company which speculates in the stock market orders a bank that it owns to send a FedWire for $10 million to a party from which it has bought stock. If, as is often the case, the funds to be wired out are not in the parent company's bank account, the bank may incur an overdrawn account, or overdraft, at the Federal Reserve Bank for its parent's benefit. No independent judgment about the parent's creditworthiness is made. Assume that the holding company, which is in an unsound condition, becomes insolvent that day. It cannot pay its bank, and its bank in turn cannot pay the Federal Reserve. But the Federal Reserve has already made an irreversible payment to the seller of the stock. The Federal Reserve is left with a $10 million loss.

If the company which owned the bank were regulated, the likelihood of such a failure would be significantly reduced by examination and supervision.

As the hypothetical case illustrates, holding companies can transmit risk to their captive depository institutions through overdrafts, and this risk may then be transmitted by the depository institutions to the system as a whole. Unless holding company risks are controlled, through limits on activities and through examination and supervision, a captive depository institution can expose the system to whatever uncontrolled risks are inherent in its parent's unregulated business.

We make no assertion that holding company regulation eliminates risk but only that it reduces it. Reduction of risk is the primary rationale for holding company and bank regulation. Some relaxation of the current limits on bank holding company activities is under consideration and is justified, but some limits will and should remain, as will examination and supervision.

Nor do we assert that all unregulated companies are more risky than regulated ones. There are risky regulated holding companies and risky regulated depository institutions. Recent experiences in Maryland and Ohio bear this out. The proper response to that problem is not to abandon regulation but to strengthen it. There are also low-risk unregulated companies. But without an unwise expansion of regulation and control, it would be impractical to attempt to sift high-risk from low-risk firms throughout the economy. This is particularly true because such sifting, to be effective, would have to be carried out on an ongoing and continuous basis.

Due to the narrowness of the bank definition in the Bank Holding Company Act and the lack of controls on the activities of unitary savings and loan holding companies under the National Housing Act, unregulated holding companies can own depository institutions, and thus control accounts at the Federal Reserve Banks in the names of their depository institutions. In principle, such a depository institution need do little more than provide a wire terminal connected to a Federal Reserve account. Like the bank owned by the stock speculator in the hypothetical case, the depository institution might not exercise independent credit judgement in dealing with its parent. In some cases, its primary purpose could be to provide its unregulated parent with access to the payments system without the application of objective credit judgement.

3. The Solution

Although the House is still considering legislation, H.R. 20 as reported by the House Banking Committee would continue to allow unregulated companies to own depository institutions and thus participate directly in the payments system. For example, state chartered banks eligible for but not insured by the FDIC, which have access to the payments system, are not defined as banks and thus can continue to be owned by unregulated holding companies. The same would be true under S. 2181 as passed by the Senate last year. This may seem to be a small loophole, but for gaining direct access to the payments system, one small loophole is all that is needed.

The way to deal with this problem is to prevent an unregulated holding company from using any affiliated depository institution to process its payments. By an unregulated holding company, we mean a company which is not regulated to the same extent as a bank holding company or a multiple savings and loan holding company. This would cause unregulated companies to access the payments system through independent depository institutions. The system would be shielded from exposure to holding companies that are not regulated for safety and soundness. At the same time such holding companies and their affiliates would be free to access the payments system indirectly, and their owned depository institutions would be free to offer the full range of services provided by competing depository institutions.

Under this proposal only regulated holding companies would have direct payments system access through their depository institutions. The purpose of holding company regulation is to reduce risk through constraints on permissible activities, through examination and supervision, and through capital requirements. There are unquestionably risky regulated holding companies, but the proper response to that problem is to strengthen efforts at controlling that risk. There are also low-risk unregulated holding companies, but it is impractical for the government to try to determine which particular companies should be admitted to or excluded from access.

Chairman St Germain. We thank you. Now, we will hear from Ben McEnteer, who appears on behalf of the Conference of State Bank Supervisors.

STATEMENT OF BEN McENTEER, SECRETARY OF BANKING OF THE COMMONWEALTH OF PENNSYLVANIA, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. McEnteer. Thank you, Mr. Chairman. I am Ben McEnteer, secretary of banking of the Commonwealth of Pennsylvania, testifying on behalf of the Conference of State Bank Supervisors.

We are pleased to have this opportunity to testify. The State banking departments in the Office of the Comptroller act as primary regulators of the institutions they charter. As the primary regulators, both are charged with broad public interest responsibility toward the entire community served by the banks they regulate.

In the past 2 years, a number of bank failures has brought the role of the FDIC to the forefront. As the Federal insurer of deposits, it must concern itself with both the decline in public confidence in our financial institutions and the need to preserve the assets of the insurance fund.

The FDIC has done well in fulfilling its statutory responsibility during these difficult times. It must be remembered, however, that the role of the FDIC is limited by its charter. And that that role does not encompass the full breadth of public interest and concerns embodied in our system of bank regulation.

Therefore, as in most areas of modern bank regulation, a great deal of cooperation is required between the primary bank regulator and the FDIC.

The concept of a risk-related premium for deposit insurance has a significant initial appeal. However, CSBS does not believe that the skills and technology are available today to predict far in advance which institutions will fail.

The ability to develop a risk-related premium is therefore suspect. Bank supervision is closer to an art, requiring skills and judgment, than it is to a science relying on quantifiable measures which leave time adequate to predict failures.

This leads to the conclusion that the blanket assessment of risk would be essentially arbitrary. Risks should be associated with what an individual institution is doing in a specific market, and should take into consideration the institution's performance record.

CSBS does not endorse the concept of public disclosure as a supervisory tool and believes improper public disclosure would be counterproductive, for the reasons stated in my written testimony.

At face value, the modified payout plan as employed by the FDIC would appear to encourage market discipline and to lessen short-term disruption among insured depositors. However, in practice, neither benefit is accrued, for the reasons stated in my written testimony.

The inclusion of subordinated debt as part of total capital, while conceptually sound, may also prove to be discriminatory in effect, for the reasons contained in my submitted testimony.

CSBS believes there is no need for the Federal Reserve System and the FDIC to handle day to day regulation of state chartered banks.

The Federal Deposit Insurance Corporation and the Federal Reserve System, in keeping with their specialized roles, should exercise examination and supervisory responsibility only as extensions of and necessary complements to the primary regulators.

CSBS has developed two voluntary programs—Department Self-Evaluation and State Banking Department Accreditation. They are described in my written statement.

CSBS believes that once a State has completed this review and has been accredited, Federal agencies should accept the examination reports and findings of that State unless the agency can show cause why it should not.

Mr. Chairman, this completes my shortened and brief remarks. I'll be happy to answer any questions you or the other members of the subcommittee might have.

[The prepared statement of Mr. McEnteer follows:]

STATEMENT OF MR. BEN McENTEER

ON BEHALF OF

THE CONFERENCE OF STATE BANK SUPERVISORS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

RE: THE DEPOSIT INSURANCE SYSTEM AND RELATED
BANK SUPERVISORY MATTERS

OCTOBER 3, 1985

Mr. Chairman, members of the Committee, I am Ben McEnteer, Secretary of Banking for the Commonwealth of Pennsylvania and Chairman of the Supervisory Procedures Committee of the Conference of State Bank Supervisors, on whose behalf I am testifying today.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, examine, supervise and regulate the approximately 10,500 state-chartered commercial and savings banks of the nation. Created in the early 20th Century as a clearing house for the ideas of the state bank supervisors on common problems, CSBS has evolved into the major champion of our decentralized American banking and bank regulatory structures. In addition, the Conference has become the most significant single source of educational and research services aimed at strengthening individual state banking departments.

We are pleased to have this opportunity to testify regarding the deposit insurance system, the possible reform of that system and related bank supervisory matters.

OVERVIEW

Now is certainly an appropriate time for removal of excessive and burdensome regulatory controls, including elimination of overlapping and duplicative examination and supervisory reviews, especially between state and federal agencies. In addition, some expansion of bank and bank holding company roles may be necessary to meet market challenges.

However, CSBS believes current market conditions dictate that now is not the time for major changes in regulatory structure. Financial institution management teams are and will be sufficiently challenged by current business conditions without adding to their problems by creating unfamiliar regulatory structures. Regulators, too, do not need to be diverted from the essential task of maintaining institutional safety and soundness. At this time, the illusion of progress through massive reorganization could have important real costs.

There are ways to lessen greatly the regulatory burden without disruption of bank or regulatory functions. There are obvious benefits, for example, in establishing parity between state banking departments and the Office of the Comptroller of the Currency.

CSBS has developed a program which would largely remove the FDIC and Federal Reserve from the routine supervision and examination of healthy state-chartered banks. Such a program would lower federal expenditures, reduce examination costs to banks and the public at large, increase resources that can be used in the handling of both state and national problem banks and free manpower at the Federal Reserve for other regulatory tasks. Lifting the regulatory burden of duplicative supervision would, in itself be a major accomplishment.

You, the Congress, have adopted a clear and consistent national policy of avoiding excessive concentrations of economic and financial resources. That principle is a cornerstone of the dual banking system, with its emphasis on decentralized regulatory authority. While value judgments must always be made as to questions of degree in applying such a broad policy, the Conference would balk at any suggestion that a reappraisal of that policy, itself, is necessary.

THE DUAL BANKING SYSTEM

The primary goal of the Conference of State Bank Supervisors is to serve the public interest through the maintenance of a viable, decentralized dual banking system as an important link in our system of state/federal checks and balances. Freedom of conversion between state and federal charters provides a major safeguard against regulatory monopoly and its inherent excesses.

As I have noted, Congress has consistently sought to preserve authority over financial resources at the local level, maintaining a wide dispersion of control both as to ownership and as to regulation. It should be emphasized that the Conference believes that a broad range of both sizes and types of institutions is necessary to a healthy economy. Large national institutions and holding companies are vital to our economic well-being in that they have a deposit base which enables them to make the size and type of loans necessary to finance large corporations. Banks and holding companies with a regional outlook and those with a local perspective, similarly, have a specific market sector to which they are attuned and which they endeavor to serve. History has shown the dual banking system to accommodate the needs of all banking institutions, while assuring sensitivity to the financial and economic needs of both individual communities and large corporations.

Our current banking system is not only efficient, it is sensitive to our long-range national economic needs in ways which no other system can match. Benefits which flow from it include:

. Diversity of Both Size and Type of Institution -- This diversity insures that all geographic areas and all sectors of the economy will be adequately served.

. Diversity of Regulation -- The prevention of monopoly in regulation insures against unduly burdensome regulation and against undue influence being attained by any public or private interest group.

. Competition -- The maintenance of the entry level and discrete areas of competition guarantees a wider range of institutions and services among which the public can shop.

. Flexibility -- The ability of institutions and regulators to take into account differences in the economies of the markets which they serve insures that local as well as worldwide needs will not be ignored.

. Responsiveness -- The accessibility of bank management to their community and of regulators to bankers under their jurisdiction guarantees rapid, informed and appropriate reactions to problems and to changing local needs.

. Innovation -- The creative tension between the systems of state and federal institutions has led to innovation in legislation and regulation, with state systems serving as laboratories for change.

These are benefits which Congress has fostered by adopting a consistent and deliberate course of action to insure equality of competition and wide dispersion of control over financial resources.

REFORM OF THE DEPOSIT INSURANCE SYSTEM

Our unique American dual banking system is marked by shared responsibility between several agencies in different roles. The state banking departments and the Office of the Comptroller of the Currency act as the primary regulators of the institutions they charter. As the primary regulators, both are charged with a broad public interest responsibility toward the entire community served by the banks they regulate.

The majority of bank failures historically have been attributed to fraud, improper loans to bank-related individuals and managerial weakness. These matters are the responsibility of the primary regulator. In recent failures it is possible to discover some of all these elements. However, in the case of widespread institutional failures, the state of the economy and economic policy can be seen as major contributing factors. Macroeconomic variables cannot, for the most part, be overcome by regulatory fiat.

In the past two years the number of bank failures has reached post-depression records. This situation has brought the role of the FDIC to the forefront. As the Federal insurer of deposits, it must concern itself with both the decline in public confidence in our financial institutions and the need to preserve the assets of the insurance fund. The FDIC has done well in fulfilling its statutory responsibility during these difficult times. It must be remembered, however, that the role of the FDIC is limited by its charter and that that role does not encompass the full breadth of public interest concerns embodied in our system of bank regulation.

It has always been the responsibility of the primary regulator to determine both the appropriate time for a bank to be closed and the circumstances thereof. Obviously, there are implications for the insurer of the institution in both the timing and the way in which the closing is handled. Therefore, as in most areas of modern bank regulation a great deal of cooperation is required between the primary bank regulator and the FDIC.

Most state statutes provide a rather specific description of the conditions that would require the respective Supervisor to close the bank. For all practical purposes the state is bound by those requirements. However, state bank supervisors do exercise a degree of judgmental discretion in dealing with institutions that are on courses leading to failure. Every effort is made to restore problem institutions to a healthy state and maintain their services to the community. There is a point, however, where the primary regulator can determine that the erosion of equity capital will continue unabated and that termination of the charter by the chartering authority is the least undesirable of existing options.

Once it becomes apparent that an institution must be closed, the timeliness of actions and selection of procedures to be followed is critical in bringing about a favorable resolution of the situation. Whether we are dealing with a critically wounded institution or a closed one, the disposition should take the form that is least disruptive to the trade area economy, most efficient, and least costly to society as a whole. Since each failure situation presents a new set of particularized circumstances, each with its own problems, it is not possible to have a general rule as to the appropriate way to manage a failure. It must be remembered that merger, purchase and assumption, conservatorship, and liquidation are merely tools, the choice of which depends on the likelihood that each will fashion the desired end in a particular set of circumstances. It is important that the respective interests of all segments of the public be considered. We believe it preferable to tailor a presciption to meet each specific situation with the primary regulator taking the lead. Experience has shown that an efficient and minimally disruptive solution can be accomplished at a relatively low cost to the FDIC fund. In some cases, the regulatory tool selected to meet broader objectives may not represent the lowest projected cost. Historically, however, there has not been a wide spread between the actual loss figures for the various tools. Given the purposes for which the FDIC fund was established, it is often appropriate for the fund to absorb an incremental additional cost in order to maintain services in a trade area, public confidence in financial institutions and stability in the banking system.

CSBS would oppose attempts to amend section 116 of the Garn-St Germain Depository Institutions Act of 1982 to allow the FDIC to arrange the sale of the assets of a "failing" bank rather than a bank which has been closed. First, such an amendment is unnecessary. State laws and regulations have provided adequate flexibility to arrange such transactions and, in several cases, have been specifically amended to accomodate the interests of the FDIC in handling failing banks. Second, allowing the FDIC to, in essence, close a bank would be a severe breach of our system of bank chartering and regulation. Third, allowing the insurer to close an institution may well lead to closing institutions for the wrong reason: protection of the insurance fund.

The FDIC fund was created to protect depositors and to promote the stability of the banking system. Banks have contributed to the fund for these purposes. An incremental cost to the fund, incurred to serve the broader policy objectives set by Congress, is often appropriate and best serves the public interest.

At this time, I would simply note for the record, that CSBS would oppose combining the FDIC and the FSLIC. We have testified to this end on several occasions and would not belabor the point at this juncture.

The concept of a risk related premium for deposit insurance has a significant initial appeal. It seems to make good sense that an institution that is behaving in a risky or an extraordinarily aggressive manner should pay a higher premium for insurance coverage than other institutions. In recent months, the exercise of investment powers beyond the traditional scope of banking and overly aggressive use of brokered funds have been suggested as evidence of greater risk for an institution. Institutions that give the appearance of running lower risks by tending to their knitting, so to speak, and serving their local communities should probably incur lower premium costs.

However, recent history has shown that even the most conservatively run institution can fall into the trap of adverse economic conditions such as volatile interest rates, declines in commodity prices, and declining real estate values. Many of these adverse conditions reflect fiscal and monetary policy decisions which have caused individual institutions to suffer. The point is that the risk of doing the business of banking has increased for those confined to traditional activities as well as for those who have expanded their range of services. Of course, the federal safety net sits under all of these institutions in some degree or another, with an increasingly open admission that some very large banks are fail-safe because their failure would severely harm the entire international financial system.

Thus, the two major problems associated with a risk-based deposit insurance premium are determining the appropriate measure of risk for various activities of the institution, including the question of who should make this determination, and determining the difference in premium charge sufficient to produce that desired effect. Presumably, a higher premium should make the management of an institution think twice before commencing a rated activity or conversely, should cover the cost of greater losses to the insurance fund resulting from institutions engaging in such activities. An initial determination must be made whether premiums should be set on a group rate basis, like medical insurance, or on a scale of groupings based on common characteristics, or simply on a bank-by-bank analysis. Given that CSBS does not believe that the skills and technology are available today to predict far in advance which institutions will fail, the ability to develop a risk related premium is weakened. Bank supervision is closer to an art requiring skills and judgment than it is to a science relying on quantifiable measures with lead time adequate to predict failures. This leads to the conclusion that the blanket assessment of risk would be essentially arbitrary and that risk assessment might have to be done on a bank-by-bank basis. In assessing risk, it must be determined whether more exposure to loss would result from in institution standing pat or from engaging in a wider range of activities.

Assigning a flat risk rating to a given activity would lead to gross inaccuracies. Each activity will vary in its risk factor, depending on variables such as location, capital or managerial skill. An activity which is risky in California may be perfectly safe and profitable in Virginia. In point of fact, an activity which is risky in Blacksburg, Virginia, may be perfectly safe and profitable in Alexandria, Virginia. Moreover, an activity which is risky in Alexandria if performed by Bank X may be perfectly safe and profitable in Alexandria if performed by Banker A. Risk assessment requires a knowledge of the activity, the market and the people involved. The extent to which a federal regulator or a state regulator, an insurer or a primary regulator, can best make those judgments is a critical question in setting up a system of risk assessment.

Risk should be associated with what an individual institution is doing in a specific market and should take into consideration the institution's performance record. This case-by-case assessment would not lend itself to generalized formulae. Rather, the determination of a risk premium should be the responsibility of the primary regulator, which has the ability to delve into the specifics of an individual case to assemble and analyze the relevant information.

The phenomenon of the "fail-safe" bank creates another problem for a risk-based system. Since, by definition, there is no chance of failure in a "fail-safe" institution, the risk related premium for these 25 to 100 large institutions would approach zero. Therefore, either the activities of these extremely large banks would have to be restricted to traditional services or a way of projecting potential cost to the insurance fund in a "fail-safe" scenario would have to be independently developed and applied. Yet, if potential cost to the insurance fund is to be the standard for risk assessment, the smallest institutions should be the least restricted in their non-traditional activities. Of course, protection of the insurance fund and assessment of risk to the fund should not be the objective of this exercise.

The concept originally underlying the foundation of the Federal Deposit Insurance Act was one of establishing protection for depositors. Over the years, the system has evolved through practice and regulation to become more or less a system for insuring the institution. Adoption of a risk related premium based on the health or activity of an institution is not depositor orientated and would ratify that evolution. It is true that depositors will be covered for the insured amount of their deposit, but it becomes secondary to the condition of the institution. Moreover, many arguments which have been put foreward even suggest that the truly determining factor is risk to the fund itself, that you must insure the insurer.

CSBS, over the years, has held - and so testified - tnat increasing deposit insurance coverage had removed market discipline from the industry. If there would be a politically acceptable way of lowering the maximum deposit insurance coverage back to $40,000 we believe that it would return the focus to the depositor and away from the institution. Furthermore, such a lowering of the depositor insurance coverage would automatically increase the opportunity for market discipline to work its way as depositors in the $40,000 to $100,000 range would be faced with having exposed funds. Small savers would remain unaffected. In addition, the ability to broker funds on an insured basis would be made more difficult. This could reduce the exposure of risk claimed to be associated with this activity.

Public criticism of any attempt to lower deposit insurance coverage could be expected and it might be difficult to explain the reality of the situation. Deposit data from 1980, which is the last time the FDIC collected information by deposit size, shows that 59.4% of the deposits of individuals, partnerships and corporations (IPC) in commercial banks were in accounts of $40,000 or less. Deposits of over $100,000 held 31.2%, leaving a mere 9.4% of IPC deposits in the accounts ranging between $40,000 and $100,000. If more current data shows that these portions have not changed greatly, public concern may be very limited. Public concern could be further mollified by maintaining the current level on IRA's and possibly other personal accounts. Certainly, the reduction of insurance coverage should be seriously considered as an alternative form of deposit insurance reform.

The use of a risk-based capital system holds many of the same difficulties as a risk related premium. It too would have to be based on what is essentially a judgmental decision made by individual regulators on a case-by-case basis. The capital assessment on an individualized basis is not a new concept to bank supervision, and runs counter to the recent efforts to achieve uniform capital standards. It appears reasonable to assume that in such a system the standard would become a floor, and upward adjustments would be made on a risk assessment basis.

A risk related capital system would discipline a bank in a more significant way than a risk related premium. It would require an institution to maintain more capital to support an asset base equal in size to that of a bank engaged in less risky activities. Forcing "risky" banks to raise additional capital creates a trauma for the ownership and management of the bank, because they run the risk of having to dilute their control of the institution, something most are reluctant to do. Customers and the public at large would actually gain from the process, as increased capital in the bank is made available to protect their interests.

One drawback to this concept relates to institutions which might benefit from new products or services, but which have deteriorated to a point where it is all but impossible to raise new capital. Again, the difficulty in accurately forecasting the future condition of a bank interferes with the current assessment of risk upon which to base capital requirements.

CSBS does not endorse the concept of public disclosure as a supervisory tool and believes improper public disclosure would be counterproductive. CSBS recommends that if, for some unforeseen reason, public disclosure must be used as a supervisory tool in the regulation of financial institutions, its requirements should emphasize deterrence rather than punishment for the institutions, be clearly understandable to and understood by the general public, be phased in on an orderly basis and should have uniform and consistent application to all types of financial institutions. As an idealistic concept, public disclosure to protect interests of innocent citizens has a measure of validity. Disclosure proposals to date, however, have not been primarily for that purpose and/or have not met the aforementioned criteria necessary to meet the public interest test.

Confidentiality of information regarding the financial conditions of banks is not a historical accident. It is naive to believe that an adequate level of understanding of such information can be readily achieved or that a run on a bank could not occur as a result of misunderstood or misinterpreted information.

The stated objective of the FDIC in calling for increased disclosure of bank information to the public is to promote better informed customer decisions and, thus, more effective market discipline. CSBS does not believe that this purpose would be served in any large measure. Large, sophisticated depositors are already aware of publicly available data, and other depositors are unlikely to be reached as to data availability and its use. Even the news media with its propensity to misinterpret data is already aware of public information and, perhaps fortunately, has not widely disseminated their versions of it.

Written statements often can be misinterpreted or have several meanings. Obviously, institutions will desire to present themselves in the most favorable light, and skilled draftsmen will be retained in some case to maximize the gain and/or minimize the loss from public releases of narrative explanations of data. At the least, a condition is being created that can lead to significant misinformation - intentional or not - by encouraging public demands for narrative explanations of data from the institutions.

The legal responsibility for the accuracy of information must be borne by the disseminator of the information. Thus, by requiring banks to disseminate information, the FDIC would be increasing the risk exposure of banks. Legal liability for simple reporting errors could be all too real. By legally absolving itself from passing on the accuracy and adequacy of the information, the FDIC, with full knowledge of the institution via a bank examination report and other analytical tools, indicates disengagement from the passage of information between the regulated and the public.

Requiring the disclosure of enforcement actions might actually work against improved bank supervision. The required disclosure of cease and desist orders could cause both state and federal regulators to withhold issuance in borderline situations to avoid possible inappropriate adverse public reaction as a result of disclosure. This would be extremely counter-productive, since the proper use of cease and desist orders has been one of the most effective supervisory tools in recent years.

Finally, there is great potential for unfairness in the application of public disclosure proposals. Proposals to date have not applied evenly to all financial institutions. State-chartered nonmember banks, in particular, have been singled out. Banks and thrifts insured by the FDIC have been singled out to release more data than other financial institutions. These subject proposals, if adopted, would mean that more regulation would be imposed on the already highly regulated at a time when nontraditional but competitive depository-type institutions are permitted to operate with less supervisory burden. Even-handedness in the application of public disclosure proposals, to date, remains an elusive goal.

Public disclosure proposals have many aspects of prescribing a cure that is worse than the illness. The restoration of weak financial institutions back to health is normally the goal of bank supervision. The disclosure of reports, regulatory judgments and actions can be justified as an additional supervisory tool only if it is presented in a constructive manner and serves the long run public interest.

Under the modified pay-off plan, as employed by the FDIC, depositors with sums beyond the insured amount receive an immediate, partial payment on the uninsured portion of their funds based on FDIC estimates of recovery. Under the normal pay-off method these depositors receive nothing until the liquidation process is well under way. Furthermore, under the modified pay-off plan, depositors with insured deposits in the bank are able to have immediate access to their funds. At face value, this plan would appear to encourage market discipline and to lessen short-term disruption among insured depositors.

However, in practice, neither benefit has accrued. Small commercial banks have been singled out for use of the modified pay-off plan, while large "fail safe" banks and thrift banks have been exempted. The net effect has not been to enforce market discipline, but to force the relocation of uninsured deposits from community banks to money center banks. The long-term economic disruption which occurs is far more significant than the short-term benefit of lessened disruption among insured depositors.

In addition, the purchase and assumption transaction is acknowledged to be the least disruptive means of handling a failing institution, at a relatively low cost to the FDIC insurance fund. Increased use of the modified pay-off plan as a means of inducing market discipline has often meant foregoing use of purchase and assumption, the preferrred means of dissolution. Therefore, use of the modified pay-off plan often represents a real cost to both affected communities and the FDIC. On the other hand, the modified pay-off plan could be an acceptable method for handling failing institutions for which merger partners cannot be located, if even-handedly applied. CSBS would suggest that its use be confined to these instances.

The inclusion of subordinated debt as part of total capital, while conceptually sound, may also prove to be discriminatory in effect. Very few small banks "go to the market" and issue debt securities. Large institutions obtain debt that would apply to capital requirements in the open market for less cost while small banks must borrow from a larger bank at greater cost or seek equity capital, the most costly form of all.

THE EXAMINATION AND SUPERVISION OF STATE-CHARTERED BANKS

The vital importance of a sound payment mechanism has led government agencies which charter banks -- the Comptroller of the Currency and state bank supervisors -- to require safety and soundness regulation and inspection for decades, consisting of 1) onsite examination of a bank's books and records, 2) promulgation of general rules to be followed by all banks being regulated, and 3) specific administrative decisions effecting structure; e.g., branch openings, mergers and acquisitions.

On a secondary level, banks do, of course, deal with many other federal agencies, the two most prominent of which are the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve System (FRS). The FDIC has an insurer's interest in the safety of bank deposits and a liquidator's role under federal and many state statutes. The FRS, in addition to its vital role in determining and carrying out monetary policy, regulates to some degree the approximately 1,000 commercial banks which are state-chartered members of the FRS.

CSBS believe there is no need for the FRS and FDIC to handle day-to-day regulation of state-chartered banks. To avoid wasteful duplication of efforts and to maintain a viable, decentralized dual banking system requires the recognition of state banking departments and the Comptroller of the Currency as the primary regulators of respective state and national banks. The Federal Deposit Insurance Corporation and the Federal Reserve System, in keeping with their specialized roles, should exercise examination/supervisory responsibility only as extensions of and necessary complements to the primary regulators and should not discriminate against the state system. The current level of presence of the FDIC and the FRS in the examination and regulation of state-chartered banks is a wasteful use of banks' and public funds and an unjustified incursion into the proper responsibility of the states.

The most significant feature of duplication and redundancy in bank supervision is the double track that each state-chartered institution must follow in regulation and examination, as well as in control of market entry and expansion. Almost step for step, most state-chartered banks have to follow a similar and largely redundant track with either the FDIC or the FRS. In contrast, most national banks are regulated by a single entity, the Comptroller of the Currency. Although all national banks are insured by the FDIC and all are required by law to be members of the FRS, neither the FDIC nor the FRS routinely is involved in the supervision and regulation of national banks. The FRS and FDIC basically accept the recommendations, opinions and examination findings of the Comptroller in meeting their responsibilities. States generally believe that the FRS and FDIC should accord them the same recognition as the Comptroller in carrying out their functions. This would mean a stepping back by these specialized federal agencies from their involvement in examination, regulation and the approval process of applications for state-chartered banks and some increase in their regulatory presence with national banks.

In January 1981 the General Accounting Office completed a report entitled, Federal Examination Of Financial Institutions: Issues That Need To Be Resolved. This GAO study goes to some length in detailing the duplication in the examination of financial institutions by state and federal agencies. It recommends greater reliance by the federal agencies upon the state reports. Another analysis completed in 1980 was State and Federal Regulation of Commercial Banks, by Leonard Lapidus and others, under the general sponsorship of the Federal Deposit Insurance Corporation. Dr. Lapidus, functioning as a quasi-independent contractor, also recommended increased reliance upon the work product of the state banking departments.

Duplicative supervision of state banks should be reduced, with the role of the FDIC limited to that amount of examination and supervision of both state and national banks necessary to safeguard insured deposits and preserve the integrity of the insurance fund. Such a reduction in the FDIC's role in state bank examinations would eliminate unnecessary duplicative examinations, reduce expenses and allow the FDIC to increase its insurance reserves to protect depositors of failed banks. In addition, the FDIC's resources could then be used to better represent the insurer's interest in troubled national banks. The release of Fed personnel and resources to pursue monetary policy goals would parallel those of the FDIC.

CSBS has developed two voluntary programs -- Department Self-Evaluation and State Banking Department Accreditation -- designed to help state regulators preserve the current dual banking system and meet their own, diverse professional and managerial needs. The goals of these programs are to strengthen state banking department capabilities to assure the safety and soundness of banking within each respective state, and to achieve recognition of the high level of capability within the state bank regulatory system.

States considering accreditation first evaluate themselves, using the Self-Evaluation Guide which is contained in the program guide. The approximately 100 criteria of the Self-Evaluation Guide provide a department with a list of those items that other regulators consider essential in maintaining a superior department. If deficiencies in the department are discovered, the Self-Evaluation criteria produces standards against which improvement may be measured. When the department has removed its shortcomings, if any, it may decide to request accreditation.

Accreditation entails forwarding to CSBS a completed self-evaluation, together with appropriate narrative and documentary materials. This material is reviewed by a panel of distinquished regulators who then visit the department and perform their own evaluation. The report of this visitation team is reviewed by a second, audit panel to ensure consistency from state to state, and act as a quality control mechanism. If recommendations are favorable, the decision is made by CSBS to accredit for a five-year period, subject to annual review and renewal.

No federal agency undergoes a comparable, rigorous standards review. CSBS believes that once a state has completed this review and has been accredited, federal agencies should accept the examination reports and findings of that state unless the agency can show cause why it should not. In essence, the burden of proof of the quality of state supervision would be shifted from the state to the federal agency in accredited states. Of course, the FDIC would continue its presence in the examination and supervision of state-chartered problem banks to the same extent it had such a presence in national banks. It is of note that, in developing its review programs, CSBS invited participation by the federal agencies. That door remains open.

To the extent that Congress may feel that a federal agency should pass judgment on the state accreditation program, CSBS believes that the responsible federal agency should be one which has no vested interest in the outcome. Of course, in principle, we see no reason or need for federal agencies to pass independent judgment on the quality of state banking departments which have been accredited.

CSBS would vehemently oppose any proposal to make a central federal regulatory agency, especially the agency responsible for chartering and regulating national banks, responsible for federal regulation, supervision and examination of state-chartered banks. Such a move would tend to increase, rather than decrease, the burden of duplicative supervision now borne by state-chartered institutions. It would greatly weaken the attraction of a state charter and enhance the ability of the federal banking agency to bring about charter conversions. We recognize the valid interests of the FDIC and the Fed in the supervision of state-chartered institutions, as mandated by their specialized roles. The chartering agency for national banks, the primary regulator of those institutions, has no valid interest in the regulation of state-chartered institutions. To state otherwise is to reject the whole notion of a valid dual banking system.

Moreover, the creation of a Federal Banking Agency, or any other such major restructuring should not be undertaken at this point in time. As I noted at the outset, CSBS believes current market conditions dictate that now is not the time for major changes in regulatory structure. Financial institution management teams are and will be sufficiently challenged by current business conditions without adding to their problems by creating unfamiliar regulatory structures. Regulators, too, do not need to be diverted from the essential task of maintaining institutional safety and soundness. At this time, the illusion of progress through massive reorganization could have important real costs.

Chairman **St Germain**. Thank you, Mr. McEnteer.

Now we will hear from Gerald J. Levy, appearing on behalf of the U.S. League of Savings Institutions. Mr. Levy, you may proceed.

STATEMENT OF GERALD LEVY, PRESIDENT, GUARANTY SAVINGS AND LOAN ASSOCIATION, MILWAUKEE, WI, ON BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

Mr. **Levy**. Thank you, Mr. Chairman.

Mr. Chairman, members of the committee, my name is Gerald Levy. I am president of Guaranty Savings and Loan Association of Milwaukee, WI. I am appearing here today in my role as vice chairman of the U.S. League of Savings Institutions.

At the outset, Mr. Chairman, let me commend you on the excellent timing of these hearings. Congressional review of the need for modifications in the Federal deposit insurance system definitely is in order, considering the unusual stresses to which the FSLIC and the FDIC are being subjected as a consequence of the financial pressures that many of the institutions they insure are encountering.

The U.S. League has been devoting a great deal of time to attempting to develop recommendations in the area under review today, and the results of our efforts are spelled out in detail in our written statement and its appendices.

In my verbal remarks, I would like to focus on several key points of particular importance to our business. Above all, let me stress our conviction that a merger of the FSLIC with the FDIC would in no sense represent an appropriate response to the situation.

First, it would be unjustified financially. Looking at the strength of the FSLIC, although its insurance fund shrank somewhat in 1984, its reserves, currently $5.3 billion, remain far above the crisis level. Also, with income running at an annual level of $2.3 billion, including the special assessments, the agency has a strong cash flow.

Moreover, although asset-based problems have emerged as a major source of concern, the central economic problem for our business remains our low-yield, fixed-rate mortgage loans, which, fortunately, are sound credits.

As a second matter, we are convinced that having a single system that unites the chartering, insuring and liquidity-providing functions has provided us with an excellent, creative, highly coordinated system of regulation and supervision that has functioned very, very capably throughout a period of extreme stress.

The system consistently has been marked by a commendable willingness to take prompt, bold action, as evidenced by the direct investment regulation, growth restrictions, acquisition, development and construction loan limitations, and other initiatives, when necessary to protect savings institutions and their depositors.

It would be a terrible mistake to disassemble this structure by dismantling the FSLIC.

Finally, consolidation would mean that a substantial segment of the industry, those with State charters, no longer would have a primary Federal regulator that was institutionally sensitive to the importance of the thrift institutions' specialized home finance mission.

We believe the ultimate result of a merger would be to unravel the entire Federal regulatory structure designed to assure the continued existence of depository institutions committed to the provision of mortgage credit.

This would be a victory for those who, believing public policy has been too supportive of housing, long have worked towards depository homogenization. But it would represent a dramatic setback for the millions of Americans who aspire to the dream of home ownership.

While the problems facing the FSLIC are serious, we are fully convinced they are manageable and can be resolved without drawing on resources, whether from the American taxpayer or the FDIC, from outside our system.

One of our primary resources is the Federal Home Loan Bank System. The 12-district Federal home loan banks operate what amounts to a central banking system for the savings institution industry.

Furthermore, under our regulatory system, the banks are deeply and directly involved in the supervisory process. Financially, the Federal home loan banks are very strong, with net worth of approximately $9 billion. This results from a conservative management style, particularly with regard to the payment of dividends.

While the financial strength the banks have built up over the years already has proved useful to the FSLIC through advances to members and direct loans to the FSLIC, a new technique, creation of a special asset management subsidiary, promises to leverage that usefulness substantially.

Before proceeding further, let me say that we realize that there is a great deal of interest in the subsidiary and league staff will be visiting members of this committee in the near future to discuss the concept more fully.

This subsidiary would be a special, private sector corporation. And I would say, thinking of the headline in this morning's Wall Street Journal about the forming of an agency, that this would not be an agency. It would be a private sector corporation, a new savings and loan, jointly owned and capitalized by the FSLIC and the Federal home loan banks, that would obtain receivership assets from the FSLIC and employ a staff of experts to manage and dispose of those assets on the most favorable basis.

The FSLIC would be given a mix of stock and notes for the assets and the subsidiary would pay off the notes by borrowing funds on the open market, thus providing the FSLIC with a welcome cash infusion.

Chairman St Germain. By "assets," you're talking about mortgages?

Mr. Levy. We are talking about real estate that is now held by the FSLIC, something close to $3 billion. Those were mortgages on real estate that has been taken over by the FSLIC.

Chairman St Germain. Now, would you use the actual balance due on those mortgages, or would you use fair market value?

Mr. Levy. Mr. Chairman, our understanding is that a good bit of the $3 billion that is now held already has been marked down, so that——

Chairman St Germain. It's a fair market value?

Mr. Levy. Yes. And it would go into the corporation at fair market value.

Use of the asset management subsidiary would benefit significantly the FSLIC and our business by permitting the most profitable disposition of FSLIC assets and by serving as a vehicle for mobilizing some of the excess capital of the Federal Home Loan Bank System to assist the institution corporation.

Let me emphasize, however, that, notwithstanding the importance of the Federal home loan bank financial participation in the subsidiary, the Federal home loan bank stake would not be open-ended. The banks' ability to borrow funds at favorable rates for relending as advances is vital to the health of our industry; and it would be a mistake for them to invest so much in the subsidiary that their borrowing costs would be significantly affected.

My final point on the subsidiary is that it should not be confused with the Federal home loan banks' making of loans to the FSLIC, that the latter, in effect, passes through to troubled institutions as part of a financial assistance package.

Confusion on this point has been widespread because of a coincidence between the time of the first public discussion of the subsidiary concept and press reports, later denied by the bank board, that the agency intended to arrange for some $20 billion in such pass-through loans.

To reiterate, the role of the asset management subsidiary, as its name suggests, would be to manage, and dispose of at the best possible price, the troubled assets contributed to it by the FSLIC.

Turning to the issue of risk-based insurance, the U.S. League is skeptical with respect to the practicality of this approach. We are, however, willing to endorse a 2-year limited scope variable premium program to enable Congress to obtain some hard information in this area.

From the standpoint of our industry, a more important and, ultimately, more beneficial step would be to free the Federal Home Loan Bank Board/FSLIC organization from the various legal constraints that prevent it from hiring, firing and compensating its personnel on a competitive, businesslike basis. The draft bill we have submitted with our written statement would accomplish this objective, and we hope you'll give it your close consideration.

Other related important steps would include providing the Bank Board with enhanced enforcement tools, developing a more focused, expert-intensive approach to dealing with supervisory problems, and relying more heavily on industry expertise in the management of financially troubled institutions.

Mr. Chairman, this concludes my remarks. I would be happy to answer any questions you have.

[The prepared statement with attached appendixes of Mr. Levy on behalf of the U.S. League of Savings Institutions follows:]

STATEMENT
OF THE
U. S. LEAGUE OF SAVINGS INSTITUTIONS

PRESENTED BY

GERALD J. LEVY, PRESIDENT

GUARANTY SAVINGS AND LOAN ASSOCIATION

MILWAUKEE, WISCONSIN

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

OF THE

UNITED STATES HOUSE OF REPRESENTATIVES

Washington, D.C.
October 3, 1985

Mr. Chairman, members of the Committee, my name is Gerald J. Levy and I am president of Guaranty Savings and Loan Association, a savings institution located in Milwaukee, Wisconsin. I welcome this opportunity to appear before you today on behalf of the U. S. League of Savings Institutions*, of which I currently am Vice Chairman.

At the outset, Mr. Chairman, please accept our compliments on the excellent timing of these hearings. Congressional review of the need for modifications in the system of federal deposit insurance definitely is in order considering the unusual stresses to which the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corporation are being subjected as a consequence of the financial pressures that many of the institutions they insure are encountering. These pressures have resulted from a variety of factors -- ranging, for example, from overly hasty deregulation of deposit interest rates, to government policies that resulted in savings institutions having portfolios full of low-yield, fixed-rate mortgages, to foreign loans made with inadequate underwriting, to irresponsible, high-flier institutions, to serious weakness in the farm and energy sectors -- but have had the uniform effect of creating enormous challenges for the deposit insurers.

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*The U. S. League of Savings Institutions, serves more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: John B. Zellars, Chairman, Atlanta, Georgia; Gerald J. Levy, Vice Chairman, Milwaukee, Wisconsin; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations; and James O. Freeman, Senior Vice President and Senior Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

Changes clearly are needed, and the U.S. League has been devoting a great deal of time to attempting to develop recommendations for improvements regarding the deposit insurance system, including the examination and supervisory processes that are so central to its ability to function properly. The bulk of my testimony will be devoted to detailing the results of our efforts.

To highlight our positions very briefly, let me stress, first, our conviction that a merger of the FSLIC with the FDIC in no sense would represent an appropriate response to the situation. Financially, it would be unjustified, and, from a regulatory standpoint, it would fragment the current efficient and unified system of thrift regulation. Ultimately, we are convinced, it would lead to a dissolution of the entire federal regulatory structure that has been developed to encourage specialized housing lending. The U.S. League must oppose in the strongest terms any initiative designed to bring about a consolidation of the deposit insurance agencies.

Certainly, the problems the FSLIC is confronting are serious. Nevertheless, we are fully convinced that they are manageable and can be resolved without drawing upon resources from outside our system -- whether those of the taxpayers or the FDIC. One of the best means of accomplishing this could be through implementation of a new concept -- the asset management subsidiary. This would be a special, private-sector corporation, jointly owned and capitalized by the FSLIC and the Federal Home Loan Banks, that would obtain receivership-derived assets from the FSLIC and employ experts to manage and dispose of those assets on the most favorable basis. Use of the asset management subsidiary would benefit significantly the FSLIC -- and our business -- by permitting the most profitable disposition of the assets the FSLIC has obtained through its receivership function, and by serving as a vehicle for use by the FSLIC, in effect, of some of the capital of the FHLBank System.

Turning to the issue of risk-based insurance, the U.S. League is skeptical with respect to the practicality of this approach. We are, however, willing to endorse a two-year, limited-scope variable premium program, integrated with variable net worth requirements, to enable Congress to obtain some hard information in this area.

From the standpoint of our industry, a more important and ultimately more beneficial step would be to free the FHLBB/FSLIC organization from the various legal constraints that prevent it from hiring, firing and compensating its personnel on a competitive, businesslike basis. This would assure it of the ability to attract and retain a staff of the size and talent necessary to provide our industry with the highly qualified supervision so critically important in today's continuously evolving financial environment, as well as to assure the most efficient use of the FSLIC insurance fund.

Other related and important steps would include enhancing the Bank Board's enforcement tools, particularly in the temporary cease-and-desist order area, developing a more focused, expert-intensive approach to dealing with supervisory problems, and relying more heavily on industry expertise in the management of financially troubled institutions. And, as you are aware, the U.S. League continues to advocate a three-year extension of the Net Worth Certificate Act as a means of preserving for the FHLBB a valuable tool for avoiding insolvencies of well-run institutions that are victims of the fixed-rate, low-yield mortgage trap and that are restructuring.

U.S. League Opposes Merger of FSLIC with FDIC

The first point I would like to cover is the possibility of a merger of the FSLIC and FDIC. Such a merger has been under considerable discussion in financial circles this year, a fact attributable to, among other factors, the pro-consolidation statements of FDIC Chairman Isaac.

The U.S. League would oppose strenuously any attempt to remove the FSLIC from Bank Board jurisdiction and consolidate that insurer with the FDIC. Such an action would be unjustified, not just from the standpoint of the relative financial problems of the FSLIC and FDIC, but in that it would diminish the effectiveness of thrift regulation, and tend to erode our ability to maintain a system of specialized housing lenders.

Regarding the strength of the FSLIC, we note that, although its insurance fund diminished in size somewhat in 1984, its reserves, currently $5.3 billion, remain far above the crisis level; moreover, with income running at an annual level of $2.3 billion (including special assessments), the agency has a strong cash flow. Further, although asset-based problems have emerged as a major source of concern for the FSLIC, the central economic problem for our business remains the interest-rate-based problem of our huge collective portfolio of underwater, fixed-rate mortgage loans. Fortunately, these investments (which, although low-yield, are sound credits) are getting to the point where significant numbers of them are beginning to roll over into market rate assets.

By contrast, the FDIC, notwithstanding its substantial reserves, faces a universe of problems that is almost entirely asset-based, and thus inherently more volatile than that confronted by the Bank Board. These problems include, most particularly, weaknesses stemming from the decline in oil prices, the farm debt situation (according to the U.S. Department of Agriculture, of the $212 billion in outstanding farm debt at the end of 1984, some 15% -- about $32 billion -- was held by insolvent farm operations), and badly underwritten foreign loans. As of May 1985, the FDIC reported that its problem list amounted to a total of 949 banks -- an increase of more than 100 from the close of 1984 -- and at current rates it appears that roughly 100 commercial banks -- a record -- will fail in 1985.

In pointing this out, we are in no sense trying to minimize the problems of the savings institution industry; the U.S. League is all too sadly familiar with their magnitude. Rather, we do so to suggest that, given the serious difficulties confronting the FDIC, that agency, as a practical matter, hardly can be regarded as being in a better position to attempt to deal with the problems of our business than is the Bank Board/FSLIC organization.

Looking at the question of effective regulation of thrift institutions, we are convinced that having a single system that unites the chartering, insuring and liquidity-providing functions has provided us with an excellent, creative, highly-coordinated system of regulation and supervision that has functioned very, very capably throughout a period of extreme stress. It would be a terrible mistake to disassemble this structure by dismantling the FSLIC -- a course which, we note, was rejected by the Vice President's Report of the Task Force on Regulation of Financial Services after careful and detailed examination of the subject.

Apart from its negative impact with regard to regulation and supervision, consolidation also would be an error in that it would mean that a substantial segment of the industry -- those thrift institutions with state charters -- no longer would have a primary federal regulator that was institutionally sensitive to the importance of thrift institution's specialized home finance mission. We are convinced that the ultimate result of a merger of the insurance funds would be an unravelling of the rest of the special federal regulatory structure designed to assure the continued existence of depository institutions committed to the provision of mortgage credit. This would be a victory for those who, believing public policy has been too supportive of housing, long have worked towards depository homogenization; but it would represent a dramatic setback for the millions of Americans who aspire to the dream of homeownership. To reiterate, the U.S. League will oppose very vigorously any attempt to merge the FDIC with the FSLIC.

U.S. League Supports Creation of Special Asset Management Subsidiary

As I noted at the beginning of this statement, the U.S. League is convinced that the problems facing the FSLIC, while serious, are manageable. Moreover, it is our belief that they can be resolved without drawing upon resources -- whether those of the American taxpayer or the FDIC -- from outside our system.

One of the primary resources available to us is the Federal Home Loan Bank system, which consists of the twelve district Federal Home Loan Banks. Authorized in 1932 by the Federal Home Loan Bank Act, the banks operate what amounts to a central banking system for the savings institution industry, serving as a major source of our liquidity. Furthermore, under our regulatory system -- which, with overall Federal Home Loan Bank Board control, ties together in an extremely coordinated and effective manner the chartering, insuring and liquidity-providing functions -- the district Federal Home Loan Banks are deeply and directly involved in the supervisory process. Each bank president is the Principal Supervisory Agent for his district, and, in addition, the FhLBanks recently have been delegated responsibility for operating the examination function.

Financially, the FHLBanks are very strong, with net worth of approximately $9 billion and reserves in excess of paid in capital of $1.7 billion. This is the fruit of a management style that over the years has been quite conservative, particularly with regard to the payment of dividends to the member savings institutions that are its stockholders.

While the financial strength the FHLBanks have built up over the years already has proved useful to the FSLIC through advances to financially troubled members and direct loans to the FSLIC, creation of a special asset management subsidiary, a new technique, promises to leverage that usefulness substantially. It will provide a means for the investment of some portion of the FHLBanks' excess capital in a subsidiary designed to make it possible for the FSLIC to realize a much better return on the assets the agency has acquired in connection with its default-prevention work.

The asset management subsidiary would be a federally chartered, private sector corporation created under authority of section 406 of the National Housing Act. Its purpose would be to manage and ultimately sell for the best possible price troubled assets the FSLIC acquires pursuant to its receivership and related functions.

Initially, the corporation would be formed as a wholly-owned FSLIC subsidiary, to which FSLIC would contribute, at market value, approximately $2 billion in assets. In return, the FSLIC would receive $500 million in stock, and notes in the amount of the balance. (It should be noted that this transaction would enable the FSLIC to clear its balance sheet of items that have been carried under accounting and budgetary rules that tend to underestimate the financial condition of the insurance fund.) Thereupon the FHLBanks would purchase enough stock to provide the corporation with an extra $300 million in cash, bringing paid-in capital to a total of $800 million. The subsidiary then would be in a position to tap the capital markets for additional funds. It could use these borrowed monies (which we do not see as necessarily coming from the FHLBanks), as well as funds derived from stock purchases by the FHLBanks and dollars resulting from sales of assets, to pay off its notes from the FSLIC -- thus providing the latter with a welcome cash infusion. It is envisioned that the FHLBanks would provide sufficient additional capital over time to assume voting control of the subsidiary.

We must emphasize that, notwithstanding the importance of FHLBank financial participation in the subsidiary, the FHLBanks' stake in the venture is not envisioned as open-ended. The ability of the FHLBanks to borrow funds at favorable rates for relending as advances is vital to the health of our industry, and it would be a mistake to require such a degree of investment in the subsidiary that the system's borrowing costs became significantly affected. As an additional means of minimizing any adverse impact on such costs, the shares purchased by the FHLBanks would have status superior to those owned by the FSLIC.

As a private corporation, the asset management subsidiary would not be bound by federal agency restrictions on hiring, firing and compensation, and accordingly would be able to attract and retain management and staff that were truly expert in the specialized business skills needed to assure that the corporation's assets were disposed of ultimately at the best possible price. The ability to operate as a private sector entity is, we are convinced, absolutely central to the successful accomplishment of the corporation's goals. Simply put, the best way to bring a high return from these assets in the free market is to have a strong, highly motivated company with a creative chief executive and a group of aggressive employees experienced in the intricacies of real estate marketing and work out techniques.

From a legal standpoint, adequate authority exists to implement the program now. Under 12 U.S.C. 1437(a), as amended by the Garn-St Germain Act, any function of the FSLIC -- in this case managing and disposing of assets -- can be delegated by the Bank Board to the FHLBanks, which arguably would appear to provide a basis for the latters' financial participation in the subsidiary, apart from authority derived from their statutory grant of incidental and general corporate powers.

Our final point regarding the subsidiary is to emphasize that it should not be confused with the FHLBanks' making of loans to the FSLIC that the latter, in effect, passes through to troubled institutions as part of a financial assistance package. Confusion on this point has been widespread because of a coincidence between the time of the first public discussion of the subsidiary concept and press reports --

quickly denied by the Bank Board -- that the agency intended to arrange for some $20 billion in such "pass through" loans. To reiterate, the role of the asset management subsidiary, as its name suggests, would be to manage and dispose of, at the best possible price, the troubled assets contributed to it by the FSLIC.

U.S. League Supports Limited, Experimental Variable Risk Premium Program

Risk based federal deposit insurance has been the topic of considerable discussion in recent years. Both the FDIC and the Bank Board have expressed support for such insurance, and have advanced a number of alternative concepts.

The initial formal proposal came from the Bank Board in 1982. That approach, reflecting the severe yield/cost spread problem of that era, focused almost exclusively on the maturity mismatch of savings institutions' balance sheets. No final action was taken, however, and as interest rates receded from peak levels and savings institutions made steady progress in restructuring, the interest in that approach as an exclusive route largely evaporated.

The current approach of the Bank Board is to focus on the asset quality exposure of savings institutions, especially additional FSLIC exposure from the exercise of expansive state-charter investment authority. The Bank Board has proposed a supplementary concept which would involve higher premium payments from institutions going beyond the boundaries with regard both to nature and extent of the powers of federal institutions. This approach would give appropriate credit to any such institutions entering new areas on a stronger capital base and would be coordinated with the agency's ongoing development of other regulatory initiatives to control the continuing exposure of institutions to interest rate risk.

By contrast, the FDIC has proposed recently to vary rebates from the statutory premium depending on the agency's determination of a commercial bank's overall riskiness. Higher charges would be imposed only if a bank had a CAMEL rating of 3, 4, or 5 and fell into an "above normal" risk category, as determined by a statistical analysis of its financial characteristics. According to the FDIC, the plan would be revenue neutral for the agency, with the higher charges imposed on riskier institutions redistributed to their more prudent competitors.

Overall, the League feels that it is crucial to maintain a regulatory "risk pricing" format which would offer institutions a variety of increased capital/increased premium alternatives to underwrite the risk exposure of the insuring agency. The highest level of specialized regulatory expertise and ultimate familiarity with the industry is necessary for that task. It is noteworthy that the FDIC admits that its skeleton proposal for a risk sensitive premium scheme, which would, in effect, reallocate the total banking sector premium expense to bear more heavily on the riskier institutions, does not offer a framework to accommodate its savings bank exposure. Its September 20 letter to insured banks states: "This technique does not lend itself to the development of a single classification system which can be applied to both commercial and savings banks because the failure risks facing these two groups of institutions are so different, that is, credit risk in the case of commercial banks and interest rate risk for savings banks."

Even the theoretically simpler task of developing a one-dimensional variable capital standard is not straightforward except in special circumstances. For that one-scale concept must accommodate the twin threats of interest rate and credit risk. The Federal Reserve Bank of New York has recently issued capital guidelines for government securities dealers. These guidelines do cover both credit risk and interest rate (or "market" risk as the terminology of the guidelines goes). Separate capital requirements to cover these expenses are computed and added together to obtain a total capital level. Such separation is possible only because the underlying securities -- government and agency securities -- are of unimpeachable quality. Thus, the only credit risk is of counterparty failure to meet obligations.

Even though this simplifies the required capital computation problem enormously, the Federal Reserve dealer capital guidelines remain extremely intricate. Where the risk of loss from, say, an adjustable rate loan cannot be segregated into credit and market risk in this way, the task becomes far more difficult. This is the basic reason why the capital and deposit premium standards have remained as they are for so long.

Our members, of course, are keenly interested in the variable premium question, and the League has devoted considerable time and effort to reviewing this issue. Our basic conclusion is that, despite the substantial theoretical appeal of the concept, we continue to have doubts as to whether the requisite regulatory engineering can be developed to convert this concept into a fairly and effectively functioning reality. Clearly, many very complicated issues of implementation remain regardless of which approach to variable premiums one favors. It will be very difficult to answer, for instance, such questions as: What is risky? How risky is it? Who makes the determination of riskiness? What criteria are used in making these determinations? How much more must be charged to defray the risk? Should premiums be related to riskiness of specific individual investments, to general categories of investments, or to the institution's general financial condition?

Although the League is unwilling to support a full-scale, open-ended authorization of variable premiums, we could support a limited, experimental, two-year program that would apply supplemental premiums to real estate development and non-financial activities. As a further matter, the experimental premium framework would be coordinated with a system of variable net worth standards that would apply to the same activities covered by risk-based insurance. With respect to developing the actual structure governing how much cost, in terms of premiums and additional net worth, risky activities would entail, we are convinced the Bank Board should be required to tie that framework to an analysis of what activities have caused the FSLIC the most losses. In addition, we believe the two-year sunset is particularly appropriate in light of the reduction of the exposure of the FSLIC fund that should be accomplished by other recent Bank Board regulatory initiatives, including the direct investment rule and restrictions on the accounting treatment for acquisition, development and construction loans.

The virtue of using a dual premium/net worth approach is that it would allow institutions to avoid the necessity of having to expense the entire regulatory "price" imposed for engaging in riskier activities, thus reducing the extent to which earnings and capital-rebuilding -- so essential to the future health of our business and the FSLIC -- otherwise would be impaired. As we envision it, the additional reserves required for risky investments would not be in the nature of permanent additions to capital, but could be redeployed with the successful disposition of the relevant investments. Such an approach, of course, would affect most heavily the investment strategies of low-net-worth institutions; in effect, organizations with surplus net worth would be rewarded for their strength with greater flexibility.

An experimental, integrated program of the kind we have outlined would provide the financial community with some necessary, and currently nonexistent, hard information about the functioning of risk-based insurance. Only when Congress has such information available will it in the end be able to decide accurately whether advocates of such insurance are advancing a practical solution to FDIC and FSLIC problems, or one which defies meaningful implementation.

Need for Restructuring of FHLBB/FSLIC

Notwithstanding our support for a limited risk-based insurance experiment, it is the position of the U.S. League that a step that would be far more beneficial would be to effect changes in the legal status of the Bank Board (and its constituent FSLIC) to enable it to maximize its ability to deal with the current and emerging challenges confronting it as a regulator. We must emphasize that circumstances -- including the deregulation of interest rates, the expansion of investment and other authorities at the state and federal level, and the ongoing negative impact on savings institutions of their portfolios of low-yield, fixed-rate mortgages -- have brought about a fundamental qualitative as well as quantitative alteration in the tasks the Bank Board must perform to discharge its responsibilities for assuring the safety and soundness of the nation's thrift industry and ensuring that the FSLIC is able to fulfill its obligations to depositors.

In our view, it is essential that the great increase in the difficulty of the job the Bank Board must perform be accompanied by a restructuring of the agency to ensure, most particularly, that its staff resources will not prove inadequate, whether in quantity or quality. The U.S. League is convinced that the current, essentially standard federal agency status of the Bank Board -- which contrasts sharply with the treatment afforded the commercial bank regulators -- simply does not allow sufficient flexibility with regard to the hiring, firing and compensation of personnel to assure us that, over time, critical regulatory challenges will continue to be met.

Accordingly, we are proposing that Congress revise the present legal framework governing the Bank Board (and the FSLIC) to enable it to function, in terms of budgeting, expenditures and personnel constraints, as a "mixed ownership government corporation," a status currently enjoyed by the Federal Deposit Insurance Corporation and the Federal Home Loan Banks. To that end, we have attached for your consideration a draft bill entitled the Savings Institutions Regulatory Improvements Act (Appendix A), together with a section-by-section analysis (Appendix B).

As our draft bill is framed, it would free the Bank Board from Office of Management and Budget budgetary oversight and review, Appropriations Committee jurisdiction, and federal personnel restrictions (except those pertaining to employers generally). It also would clarify that the Bank Board, like the FDIC, is not required to submit to OMB "apportionment" requirements, under which future expenditures must be estimated or "apportioned" on a quarterly basis, with expenditures above estimated amounts subject to OMB approval. No change would be made in the manner in which Bank Board members are appointed, however, and the General Accounting Office would continue to have audit authority over the agency, although the FSLIC would be treated like the FDIC and no longer would be subject to a mandatory annual audit requirement.

The U.S. League realizes, of course, that the Congress already has provided the Bank Board with an important agency restructuring tool in the form of the "delegation" amendment made to 12 U.S.C. 1437(a) by the Garn-St Germain Act. Indeed, the Bank Board recently utilized this authority to delegate, in effect, its examination function to the FHLBanks -- a step which we have applauded. While we support the widest possible use of section 1437(a) authority, we believe, however, that a straightforward revision of agency status along the lines contained in our draft bill is the most desirable route.

As our final point, we emphasize again that the increased costs that would accompany the restructuring we are urging would be borne by the savings institution industry rather than by the taxpayers. The Bank Board and the FSLIC derive their funds not from taxes, but from FHLBank assessments, examination fees, insurance premiums, and interest earned on the FSLIC fund. This additional expense is one we would incur gladly, however, for we believe its cost-effectiveness, in terms of assuring top-quality regulation, would be very high. The positive effects associated with such regulation -- ranging from minimizing the pressures on, and maximizing the effective use of, the FSLIC fund, to facilitating prompt and efficient processing of applications -- cannot easily be quantified in dollar terms, but clearly would be of very great financial benefit to our business.

Mr. Chairman, the U.S. League regards our proposed Savings Institutions Regulatory Improvements Act as a measure of great significance for our business and has assigned it a very high legislative priority. We would not be advancing such a proposal without the strongest sense of its importance. It is our hope that your distinguished Committee, and any other Committees with appropriate jurisdiction, will give this draft careful and prompt consideration.

New Enforcement Powers Necessary for Bank Board

As the Committee is aware, the Bank Board is extremely interested in upgrading its arsenal of enforcement tools in order to enable it to deal more quickly and effectively with the "high-flier" institutions that pose such a threat to the FSLIC. The U.S. League shares the agency's concern regarding the negative effects on the FSLIC of reckless or dishonest operators, and we have examined with great care the new powers the Bank Board is seeking, as contained in H.R. 1680, the Insured Institutions Improvements Act. Although we by no means endorse all the changes the Bank Board is urging, we have concluded that we can support important statutory changes in this area, particularly with regard to expanding the agency's authority regarding temporary cease-and-desist orders. Because our detailed views on the Bank Board's proposal are quite lengthy, we have set them forth as Appendix C, rather than reciting them in the main body of our testimony. Please bear in mind that our support for new powers is contingent upon the various modifications to the Bank Board's proposal that we describe in Appendix C; we are convinced they represent a reasonable reconciliation of the competing supervisory, due process, and public confidence issues involved.

U.S. League Supports Revised FHLBB Approach to Supervision

While the U.S. League has supported many of the FSLIC-protective regulatory initiatives that the Bank Board has implemented over the past two years, including the direct investment regulations, we continue to prefer to see problems resolved on other than a broad-bush, lowest-common-denominator basis. The prospect of new enforcement tools and enhanced staff resources raises, in our view, the possibility that at some point the agency may be able to retreat from broad regulatory initiatives and to deal more effectively with supervisory issues on a case-by-case basis.

With this in mind, we have suggested that the Bank Board begin focusing intense supervisory efforts on the activities of the kinds of high-flier institutions posing the greatest potential threat to the FSLIC. New powers and the lifting of personnel constraints would allow this approach to reach optimum effectiveness, but we believe, considering the delegation of the examination function to the FHLBanks, that the Bank Board could commence implementation now. The ultimate objective would be the development and use of highly qualified teams of examiners, lawyers and financial experts that would be able to come to grips with complicated problems with maximum speed and skill.

Let me assure this Committee that we in no way envision this program as lessening the agency's overall supervisory efforts regarding other institutions.

Disclosure and Supervision

One purported approach to enhancing supervision that we are not urging upon Congress or the Bank Board is routine disclosure of the existence of administrative enforcement orders, an approach adopted by the FDIC and the Office of the Comptroller of the Currency. The difficulties of privately insured thrifts in Ohio and Maryland should serve as a stark reminder of the great vulnerability of all financial institutions to the effects of bad publicity. We believe it is highly irresponsible for the FDIC and OCC to foster a situation that invites bad publicity, not just for the institution involved in the enforcement action, but for others as well.

In terms of whether the threat of publicity will make institutions more willing to follow regulatory direction, we firmly agree with the traditional Bank Board view that a general policy of confidentiality enhances enforcement efforts by making targets more willing to comply with orders without litigation. While it is possible that the FDIC/OCC approach might facilitate informal resolution of some individual disputes, we note that this result could be achieved without a blanket disclosure policy simply by selective targeting in appropriate cases. But as a general matter, we seriously question the desirability of a policy that would encourage informal resolution of serious cases, thus sacrificing the important procedural and other advantages flowing from issuance of a formal order.

We also question the impact of such a disclosure policy on the examination process, which essentially is conducted with the expectation of confidentiality. Institutions which realize they have a potential supervisory problem that ultimately could lead to a publicized formal order inevitably will be less forthcoming with examiners than they would under a regime where confidentiality was preserved. Information could not be developed as rapidly, slowing down the examination process and thus interfering with the Bank Board's ability to detect and respond to violations of unsafe or unsound practices at an early date.

Management Sharing Program

At this point, I would like to review for the Committee the U.S. League's Management Sharing Program, which we believe represents an excellent supervisory cost-reduction tool that could be used to relieve some of the pressure on the FSLIC insurance fund as well as some of the strain on the agency's staff. This would be accomplished through the routine employment of industry resources to manage problem physical assets and problem institutions. It would function as a supplement to the asset management subsidiary.

With respect to assuring the best resolution of cases involving problem physical assets, the program would focus on establishing a structure under which the FSLIC could identify and retain experts from inside or outside the savings institution industry who would manage those assets. This would involve creation by the FHLBanks of Regional Advisory Commissions (RACs) for this purpose; at least one would be located in each FHLBank district. Each RAC would consist of the Principal Supervisory Agent (PSA), a local FSLIC representative, the state supervisor (where state-chartered institutions are involved), and representatives of local savings institutions. Industry representatives would be appointed by the PSA and would receive some form of compensation, and RACs would have support staff who would be paid by the relevant FHLBank. Recommendations of RACs, if accepted by the PSA, would be approved automatically under delegated authority if the amount of funds involved were less than a specific figure.

In terms of dealing with problem institutions, we have recommended that the FSLIC rely routinely on a "consignment" approach whereby management expertise in effect would be hired from other savings institutions or, if necessary, commercial banks. The choice of a management agent would be the responsibility of the PSA and would be made on the basis of: (a) the willingness of management agents to place any capital at risk in the arrangement; (b) the management agent's capacity and track record; (c) a business plan submitted by each applicant; and (d) the structure of management agent compensation, including management fee, right of first refusal in subsequent mergers, transferability of such right, option on assets, branch system, and so forth.

Because of the exposure to the FSLIC caused by high-risk operating strategies on the part of troubled institutions trying to recoup losses, institutions coming under a management agent arrangement would be confined in their resuscitatory efforts to prudent practices. In particular, institutions in cases where a management agent solution was contemplated would be run strictly according to a business plan. Departure from the plan would require prior PSA approval.

As you may be aware, the Bank Board has adopted a consignment approach in a number of recent cases. While we have communicated a detailed description of our proposed program to the agency, the Bank Board has not publicized the details of the arrangements into which it has entered, and we are unaware to what extent, if any, it has drawn upon our suggestions. We remain quite enthusiastic over the cost-saving potential of our program, and are hopeful that the Bank Board will embrace significant portions of it.

U.S. League Supports Extension of Net Worth Certificate Act

Mr. Chairman, the U.S. League continues to be deeply grateful to you for your key role in assuring enactment of the Net Worth Certificate Act, and for supporting our efforts to secure an extension of that legislation. It is our hope that you and your colleagues will continue to work with us to assure that the Act's benefits will not be lost. Those benefits flow from permitting well-managed institutions to escape unnecessary insolvencies, thus avoiding the disruptions and increased financial concentration, and, potentially, some of the expenses, associated with the forced merger route, as well as from enabling the FSLIC and FDIC to devote more staff attention to resolution of truly serious cases involving problems of management or asset quality. The U.S. League believes a three-year extension of the Act would be appropriate.

We are aware that in some quarters the significance of the expiration of the program has been downplayed on the theory that the Bank Board could substitute use of income capital certificates (ICCs) for net worth certificates. ICCs were developed prior to the enactment of the Garn-St Germain Act as part of the agency's "Phoenix" program under which it provided repayable capital infusions to large insolvent institutions that it deemed would be too expensive to liquidate.

It is true that the Bank Board would have considerable flexibility to employ ICCs under 12 U.S.C. 1729(f)(1), which allows the FSLIC to make, inter alia, loans or contributions to insured institutions (1) to prevent their default, (2) to restore them to normal operation if they are in default, or (3) to lessen the risk to the FSLIC where the agency determines that severe financial conditions exist threatening the stability of a significant number of insured institutions or of insured institutions possessing significant resources. For a variety of reasons, however, we believe that renewal of the net worth certificate program would be a far superior approach to assisting well-run but financial troubled institutions than would reliance upon section 1729(f)(1) authority.

First, unlike section 1729(f)(1) assistance, which must be bottomed on subjective determinations regarding the possibility of default or recovery therefrom or the existence of "severe" financial conditions, net worth certificates basically may be provided to any well-run institution with net worth of 3% or less that is suffering operating losses. Thus, net worth certificates potentially are available to a wider variety of institutions than are ICCs, and eligibility is far easier to determine.

Second, without the renewal of the net worth certificate legislation, there would be no barrier to conditioning grants of assistance to any institutions upon agreements to merge or change management. Current law governing the program specifies that such conditions may not be imposed where the FSLIC determines that the recipient institution has, with regard to mergers, more than 6 months left of positive net worth, or in the case of management changes, more than 9 months.

Third, present law specifies that net worth certificates may be counted as capital regardless of any statutory or regulatory obstacles. Similarly, the existing net worth certificate statute also overrides any state laws that would interfere with an institution's ability to take part in the net worth certificate program. If the legislative underpinnings of the program were permitted to lapse, many state-chartered institutions could find participation in any ICC assistance plan impractical or even illegal because of the lack of an equivalent federal override regarding section 1729(f)(1) assistance.

Fourth, to assure that federal assistance is not diverted to local or state government authorities, current law states that, while an institution has net worth certificates outstanding, it shall not be liable for any tax based on deposits held or the interest or dividends paid on those deposits. Again, lapse of the program would mean the end of this protection, thus, in effect, leading, should the FSLIC embark upon a substitute assistance plan employing ICCs, to an unjustified diversion of FSLIC funds from insured institutions to state and local governments.

Finally, without the net worth certificate legislation, the FSLIC would have no authority whatsoever to provide assistance to institutions insured by private funds. Current law allows such aid, subject to certain requirements pertaining to assessment levels and indemnification.

Accordingly, in our view, the ICC approach would be a very imperfect substitute for the net worth certificate program. We are convinced that Congress should act to assure continued availability of NWCs, rather than rely upon the FSLIC's ability to issue ICCs.

As a final matter, Appendix D provides a detailed discussion of the general operation and usefulness of the net worth certificate program.

Need to Extend Emergency Authorities Contained in Title I of Garn-St Germain Act

The Net Worth Certificate Act, however, is not the only Garn-St Germain Act authority that should be extended in the interests of protecting the FSLIC and FDIC and enhancing supervision. The U.S. League commends you and this Committee for your work in approving, as part of H.R. 2707, language providing for a three-year extension extension for all the emergency authorities contained in Title I of the Act. They currently are scheduled to expire on October 15, 1985. The emergency acquisitions power created by section 123 is the best known of these, but the Act also provided valuable authority regarding conversions and receiverships that, given the distress still besetting our industry, should not be allowed to lapse.

Section 123 -- Section 116 is the FDIC analog -- essentially allows the Bank Board, as a means of conserving FSLIC's resources, to authorize virtually any kind of acquisition of a savings institution -- subject to antitrust limitations. This provision has been the source of great savings for the FSLIC, and, given the likelihood that the insurance fund will remain under considerable pressure for several years as institutions financially battered by the 1981-82 crisis attempt to regain health, promise to provide such savings in the future as well.

We oppose, however, substantive changes in the emergency acquisitions statutes of the sort contained in the Federal Savings and Loan Insurance Corporation Protection Act, H.R. 2444. That bill would strike the requirements that: (1) the Bank Board, in considering such emergency authorizations, must give consideration to the maintenance of specialized depository institutions; and (2) the agency, in authorizing those transactions, must do so pursuant to a bidding and priority frameworth basically designed to give first preference to savings institutions from the same state (and to minority institutions with respect to acquisition of minority institutions).

While the statutory framework admittedly would be somewhat easier to work with in the absence of the provisions sought to be deleted, we seriously doubt that it fairly can be blamed for causing FSLIC any excess costs with respect to assisted mergers. We must emphasize that the goals of ensuring continuation of depository specialization and local control are important ones that should continue to be linked to the emergency acquisitions authority. To reiterate, the League will resist strongly any attempt to delete these public-policy protections.

Another emergency provision that should be extended is section 121, which created section 5(p) of the Home Owners' Loan Act of 1933. Section 5(p) overrides any state or federal laws that might otherwise interfere with the Bank Board's authority to authorize mutual thrifts to convert to the federal stock form. Because the laws restricting conversions by federally-chartered savings institutions were eliminated by other permanent provisions of the Garn-St Germain Act, section 5(p) is of greatest significance to state-chartered institutions, with respect to which, of course, state law concerns remain significant.

One of the most important uses made of section 5(p) has been in connection with the Bank Board's modified conversion regulations. Under these regulations, converting, financially-troubled organizations are allowed to restrict depositor subscription rights (the lower the entity's net worth, the greater the restriction allowed), thus making it easier for single investors to make substantial initial purchases of stock. This can be an essential ingredient in a successful conversion of an institution with low net worth, for capital injections under such circumstances are far liklier to come from persons or organizations seeking control than from large numbers of small investors.

Although, as indicated, section 5(p) appears primarily significant for state institutions, we note that the statute is cited by the Bank Board in its regulation as the official source of authority for any modified conversion of an institution, regardless of its source of charter.

A third emergency authority that merits extension is section 122(d)-(g). This provision -- subject to certain safeguards designed to accommodate dual system concerns -- basically gives the Bank Board (acting through the FSLIC) the same conservatorship/receivership authority over state-chartered institutions that it has over federals. Although our impression is that federal and state thrift regulators in recent years have cooperated very well in this area, section 122 assures the Bank Board of the ability to take prompt action in the event of a disagreement that the agency believes could result in unnecessary expense to the FSLIC.

Again, Mr. Chairman, we are grateful for the efforts you and your colleagues have made, in connection with H.R. 2707, to assure extension of these very important authorities.

Extent of Deposit Insurance Coverage

Any examination of the deposit insurance system logically must pose the question -- as did the Committee in its invitation to testify -- of how much coverage should be provided. There is, of course, no "right" answer to this question. Our general view is that the limits should be such that a saver of reasonable means can accommodate comfortably his lifetime savings needs at one institution.

We believe that the current $100,000 limit accomplishes that goal for general transaction and savings accounts, but that Congress should consider establishing a $250,000 ceiling for IRA and Keogh accounts. By virtue of being long term in nature and designed to grow to meet retirement needs, such accounts, especially when boosted by a distribution from a qualified plan to an employee switching jobs, will inevitably tend to bump against ceilings, forcing depositors to seek alternative locations for their funds that may be inconvenient geographically or otherwise, or less remunerative. Because of the typical stability of such accounts, they, of course, are particularly desirable for institutions, such as home lenders, that specialize in the extension of long-term credit. As you will recall, when the general insurance limit stood at $40,000, IRA and Keogh account coverage was $100,000; we urge you to reestablish that 1:2.5 relationship by raising the retirement account ceiling to $250,000.

Although the U.S. League is aware that some support exists for lowering current deposit insurance ceilings to $40,000 or some other figure, we are convinced that the benefits of such a policy, if any, would be ephemeral, as accounts quickly would be redistributed to adjust to new ceiling norms. The drawbacks to this step, however, in terms of liquidity problems for institutions and inconvenience and unfairness to depositors, many of whom have based significant financial planning decisions on $100,000 coverage, would be substantial.

With respect to the specific issue of authorizing 100% general deposit insurance coverage, we would be very reluctant to endorse such a step, notwithstanding our awareness that in the majority of failures account holders with balances in excess of $100,000 have enjoyed on a de facto basis the same protection as their less prosperous fellow depositors. However imperfect, the current approach, we are convinced, does provide significant benefits with regard to market discipline that would be absent under a 100% coverage regime. On the other hand, we must stress that the too-big-to-fail phenomenon, as exemplified by the Continental Illinois bailout, is already eroding those benefits, which cannot be expected to endure long in a marketplace where it is the conventional wisdom that deposits in some institutions, but not others, will be 100% insured.

Insurance Fund Recapitalization

Given the pressures on the FSLIC, there has been sentiment in some quarters favoring a recapitalization of the fund. This is seen as a means of assuring that public confidence in federal deposit insurance will not be eroded by publicity over FSLIC expenditures, and of providing the agency with additional funds for its assistance activities.

As a practical matter, FSLIC-insured institutions already are participating in a FSLIC recapitalization thanks to the Bank Board's imposition this year of an additional insurance premium of 1/8 of 1% of deposits. Added to the normal 1/12 of 1% premium, this means premiums for 1985 will equal 5/24 of 1% of deposits; by contrast, commercial banks are supporting their fund at a premium level of 2/24 of 1% of deposits, less any sums rebated. Rebates, it should be noted, are not a feature of the FSLIC premium structure.

Although the 1/8 of 1% supplemental premium will add approximately $1 billion to FSLIC's coffers this year, most persons advocating recapitalization envision providing the FSLIC with a far larger sum -- say $9 billion, or approximately 1% of total industry deposits. Naturally, considering concern over the federal deficit, apart from any other factor, these funds are seen as coming, not from the taxpayers, but from the industry.

Earlier this year, the League spent considerable time attempting to develop a recapitalization plan that would bolster the FSLIC and the public's confidence in it, while avoiding the need for additional supplementary premiums. For a variety of reasons, however, we determined to shelve our plan rather than to press for authorizing legislation. First, it was assumed that the funds infused through recapitalization could be carried by institutions as assets, as opposed to being expensed, as in the case of the special assessment premiums. Unfortunately, the informal feedback we received from the accounting profession in this regard was quite discouraging, suggesting that a significant portion of the approximately $9 billion we envisioned being assessed for recapitalization purposes might have to be expensed. The devastating effect such an action would have on industry profitability and net worth acted as an extremely powerful disincentive to further pursuit of the recapitalization option.

Another drawback to recapitalization was the opportunity cost involved. Inevitably, there would be a considerable gap between what the funds provided the FSLIC would earn as compared to what they would yield if invested by the savings institution itself. This differential was regarded as a very significant negative factor by a great many of our members, who were extremely concerned about the need to put every available dollar to use in the most profitable manner in order to speed restructuring and the process of rebuilding capital. In effect, the feeling was that, on an overall basis, the system would be stronger if the dollars in question were left in the insured institutions rather than placed in the FSLIC.

A third basic reason for our retreat from recapitalization was our conviction, as already discussed, that the problems of the FSLIC, though serious, were manageable within the context of the agency's existing resources and those that could be provided by the special assessment, provided that new approaches to using these resources were put in place. Conversely, we were apprehensive that, without these new approaches, the substantial sums to be transferred under recapitalization would be managed in a less than optimal manner.Accordingly, we concluded that, under current circumstances, the most appropriate manner of dealing with FSLIC's financial situation was not the recapitalization route, with its accounting and opportunity cost problems, but that of seeking administrative -- and, where needed legislative -- steps to assure that the agency, in cooperation with the system it serves, was deploying its very considerable resources in the most effective manner.

Modified Payoff

Among the more interesting proposals for injecting increased market discipline into the system is the "modified payoff" plan that has been developed by the FDIC. Under this approach, uninsured depositors in a failed institution immediately receive a cash advance based on an FDIC estimate of the present value of the receivership collections. This is more favorable than the current liquidation regime that delays payments of claims of uninsured depositors until funds actually are collected by the receiver. It is, however, more severe than the classic purchase-and-assumption method under which all accounts, insured or uninsured, are assumed by another bank.

It appears to us that this approach strikes a reasonable balance between extending de facto coverage to uninsured depositors and forcing the latter to wait through the receivership process. We will be interested in the FDIC's experience with this technique.

The League does have two reservations about the use of modified payoffs. First, we are concerned about cost. If the general use of modified payoffs were significantly more expensive than the current approach, we believe the FDIC would have to consider very carefully whether the technique actually was proving cost-effective in terms of the market discipline benefits involved. It would be poor policy to carry out an experiment that could increase the costs of individual failures unless it could be demonstrated on an objective basis that positive results were being achieved that justified that greater expense.

As an additional matter, we have noted nothing in the FDIC's modified payoff proposal that gives us confidence that the agency is repudiating the too-big-to-fail phenomenon. Admittedly, the decision to bail out Continental Illinois resulted from a set of very compelling factors, including such things as the fear of a financial system "domino effect," apprehension over the impact of a failure on efforts to finance the federal deficit, and concern regarding the effect of a payout on the FDIC insurance fund. Any effort to impose increased market discipline on uninsured depositors in banks, however, that is not credible with regard to money center institutions can be of little benefit to the system. Indeed, its results could be quite perverse, encouraging large depositors to abandon soundly-managed small and moderate-sized thrift and commercial banking institutions and seek perceived safe havens for their funds among the nation's banking giants. We hope that Congress will strongly encourage the federal deposit insurance agencies to do their utmost to deal with the too-big-to-fail problem before equitibility and financial stability concerns necessitate 100% deposit insurance coverage and a concomitant abandonment of any pretense of market discipline based on depositor evaluation of risk.

Charging of Insurance Premiums on Foreign Deposits

One step which we believe would be appropriate immediately with regard to the too-big-to-fail situation would be to require American depositories to pay deposit insurance premiums on their foreign deposits. As it stands now, funds deposited abroad in American banks receive the benefits of de facto coverage while the banks involved -- which generally are money center institutions -- do not have to include those deposits in their premium calculations. This situation strikes us as very inequitable, and one that should be remedied at the earliest opportunity.

Capital Requirements

Apart from the variable net worth requirements that the League believes should be integrated into a risk-based premium experiment, the League also must acknowledge the need for a general increase in our industry's capital position. We estimate that the collective capital account of our business is approximately $20 billion below where it would have been had the 1981-82 crisis not occurred.

The Bank Board, of course, is keenly interested in improving the net worth of our business as a means of protecting the FSLIC and earlier this year took steps to tighten considerably the regulations governing FSLIC-insured institutions in this regard. While they do preserve fairly generous leveraging possibilities for savings institutions, this is simply a reasonable accommodation to the hopefully transient phenomenon of portfolio drag: prudently managed growth can represent a way to dilute that drag, improve earnings and bolster capital. Historically, the Bank Board's net worth requirements were not too dissimilar to those of the commercial bank regulators, and, over time, as our business restructures and recovers its ability to generate strong earnings, the agency can be relied upon to continue the process of imposing stricter capital standards.

The U.S. League believes that the pace at which capital requirements are increased should be left to the discretion of our regulator. As indicated, the Bank Board, with its interest in safeguarding the FSLIC, can be relied upon to work actively for enhanced net worth at a pace consistent with the industry's financial condition. Should Congress decide, however, to legislate a date -- seven years hence has been one suggestion -- by which thrifts and banks should be under comparable capital requirements, we would strongly urge that all details of the phase-in -- which would be of critical financial importance to our business and the housing industry it serves -- be left to be determined and implemented solely by the Bank Board. In light of our experience with the deposit interest rate decontrol administered by the Depository Institutions Deregulation Committee, we would be completely opposed to any involvement of the commercial bank regulators in establishing capital standards for institutions insured by the FSLIC.

One of the specific questions posed by the Committee in its invitation to testify concerned the suitability of subordinated debt as capital. The League notes that the Bank Board's present regulations allow subordinated debt to count toward satisfying net worth requirements, although in diminishing proportion as the term to maturity fails below the seven year mark. We believe this is reasonable, given the capital characteristics of subordinated debt and its ability to provide protection to the deposit insurance agencies. The League does not, however, support the FDIC's proposal to establish, as a means of promoting market discipline, an increased secondary capital requirement that could be met through sales of subordinated debt. For one thing, the overall 9% required capital level envisioned in the proposal strikes us as unnecessarily high. We note too that the expense to the industry of constantly going to the market with debt offerings would be very great. Moreover, we suspect competitive inequities would be generated by this approach based upon the size of institutions and the relative unwillingness of investors to accept the paper of small, rural or community institutions, however well managed, versus that of larger organizations. In particular, banks falling in the too-big-to-fail category would enjoy an unfairly privileged position -- again pointing out the fact that attempts to inject more market discipline into the system must apply in practice to money center banks as well as to smaller institutions.

As a final point under the heading of capital, we are, as noted, well aware that FSLIC-insured institutions operate under a more liberal regulatory framework in this area than do commercial banks, a fact that causes some observers to proclaim the existence of a competitive imbalance favoring our industry. The question of competitive equity regarding differing types of financial institutions cannot be answered, of course, merely by reference to one aspect of their corporate existence. While capital requirements are certainly a factor to be considered, so are the generally less liberal asset and liability authorities of savings institutions when compared to commercial banks, and the debilitating legacy of having been compelled for many years to forgo adjustable rate mortgages and to operate under mutual charters that severely limit access to the capital markets. Viewed in totality, we by no means regard the proverbial playing field as being level at the present time; it most certainly is not tilted in our favor vis-a-vis commercial banks.

Market Value Accounting

A further issue that is being raised in the market discipline context is that of switching to a market value accounting approach. Under a regime of this kind, the assets of depositories periodically would be reevaluated in terms of their present market value. Where values had declined, additional capital might have to be obtained, depending on an institution's overall net worth position.

In our view, such an approach might make sense with regard to a depository's trading portfolio, and, indeed, the Bank Board not long ago mandated such treatment regarding "dollar roll" transactions. As a general policy, however, we believe requiring across-the-board market value accounting would be very destabilizing, and, as a practical matter, would be expensive and hard to implement with regard to many asset categories. Instability particularly would be generated for organizations, such as savings institutions, that have assets which are directly affected by interest rate fluctuations. We are convinced that the market value concept would be singularly inappropriate for organizations that essentially are long term investors in mortgages or similar instruments, as opposed to entities that simply acquire such paper in connection with a short-term trading strategy.

U.S. League Continues to Support Restrictions on Brokered Funds

An additional issue on which the Committee asked witnesses to focus was that of brokered funds. Both the Bank Board and the FDIC would like to obtain legislation that would enable them to impose very tight restrictions on this form of funds acquisition.

Although the Bank Board's tightening of capital requirements and the concomitant reduction of rapid growth possibilities for savings institutions logically have taken some urgency away from the need to deal with the issue of brokered funds, the U.S. League continues to be supportive of the view that the cause of depository stability best would be served by imposing limits on insured money brokering. Money brokering too often has been associated with reckless expansion and irresponsible end-of-game strategies by failing institutions.

Nevertheless, in light of the Bank Board's net worth constraints, we believe that the possibility exists for a more tolerant attitude toward brokered funds. Specifically, it is clear that longer term brokered money can be extremely useful in the restructuring context. In our view, such funds should not be covered by any statutory restrictions placed on brokered deposits, except where the institutions involved are supervisory cases.

Role of Private Insurance

Another of the questions posed in the invitation to testify concerned whether there continues to be a role for private deposit insurance. We suspect that before very long any response we might offer may have been mooted by events; the Ohio and Maryland situations appear to have generated a powerful trend on the part of privately insured depositories in those states and in North Carolina and Massachusetts toward obtaining federal deposit insurance. For the sake of stability, we hope the FDIC and FSLIC will do everything they can to expedite the processing of such insurance applicants while maintaining the integrity of the federal accounts-insurance systems.

As a matter of policy, however, we do not advocate outlawing private insurance, notwithstanding the serious misadventures of recent months. As long as depositors and investors clearly understand the risks involved, and adequate supervision exists, we see no reason, in a capitalist economy, why the private insurance option should be foreclosed. After all, over $200 billion is currently on pseudo-deposit in money market mutual funds without the protection of federal insurance.

In terms of specific safeguards, we would suggest that depositors in privately-insured thrifts be informed explicitly that no federal or state backing exists for their deposits. Indeed, to facilitate understanding on this point, it might be appropriate that the insurer be forbidden to use the name of a state as part of its corporate title, unless the full faith and credit of the state stands behind the system. And, in terms of supervision, it appears clear that a high degree of strictness is in order. This is not to say that organizations in Ohio and Maryland were supervised any less vigilantly than their federally-insured brethren. Rather, it is by way of acknowledging the fact that the media can be relied upon to focus vast and confidence-eroding attention upon financial problems involving a privately-insured entity, thus putting such institutions in something of a "Caesar's wife" position.

Negative Impact of Tax Law Changes

As a final matter, it is important to remember, too, that the task confronting the savings industry and the FSLIC under review today by your distinguished Committee does not exist in isolation from other important issues pending before the Congress. In particular, the industry and its deposit insurer are impacted by proposals put forth in the Administration's proposal for tax simplification and reform.

I appreciate that your Committee does not have direct jurisdiction but there are three areas of particular concern in the proposal: repeal of the bad debt reserve methodology for thrift institutions' taxation and a recapture of a portion of past tax reserve accumulations; the transition to a new net operating loss carryback and carryforward pattern; and the sunsetting of special tax code provisions regarding FSLIC assistance and supervisory mergers.

The most onerous proposal would recapture a portion of bad debt accumulations equivalent to that reserved by commercial banks. Though the Administration's plan would spread this $2 billion tax liability over ten tax years, authoritative accounting treatment literature mandates that thrifts will have to recognize the entire new tax liability on their financial statements immediately, in contrast to commercial banks. The result is an industry-wide "hit" to net worth in 1986 of $2 billion -- reducing by half the net worth our organization projects will be rebuilt in the coming year if interest rates remain relatively stable. This portion of the Administration's proposal thus effectively contradicts the clear desire by many Members of this Committee and the Congress to encourage a stronger capital base for the savings institution business. It also complicates the task of the FSLIC by potentially adding to its list of institutions which fail to meet minimum net worth requirements, and by discouraging new buyers from acquiring capital-deficient institutions.

Another portion of the Administration's plan reorders the net operating loss carryforward and carryback which applies to savings institutions and commercial banks. Again, a major problem is created in the lack of an orderly transition to the new method -- especially the failure to permit thrifts to utilize fully net operating losses already incurred. Not only does this impair the financial health of companies with significant net operating loss accumulations, but it also diminishes the appeal of savings institution acquisitions to new purchasers -- again potentially enlarging the task of the FSLIC in attracting merger candidates for troubled companies.

In testimony delivered in July to the Ways and Means Committee, and again in September to Senate Finance, our organization explained in considerable detail why it is important to maintain some reserve treatment for savings institution tax purposes as well as the need for adequate net operating loss carryback and carryforward.

Yet another portion of the tax plan affects special provisions adopted at Bank Board request in the 1981 Economic Recovery Tax Act to permit the acquisition of a "financially troubled" thrift to qualify as a tax-free reorganization without regard to certain continuity of interest rules. The 1981 law also relaxed certain rules which limit the use of an acquired corporation's net operating loss carryovers by an acquiring corporation, and a companion provision in the four-year-old law provides for tax-free treatment of certain FSLIC payments to the acquiring corporation. The "staff options" presented last week to the House Ways and Means Committee would repeal these special tax code features on January 1, 1986. This would very seriously impair the FSLIC's ability to attract bidders for financially-troubled thrift institutions and greatly complicate the administration of its insurance fund. Our organization strongly supports continuation of these portions of the 1981 law. Furthermore, we see no rationale for confining these important supervisory merger tools to just the FSLIC -- they should be available to the FDIC as well.

Mr. Chairman, this concludes my remarks. I will be happy to try to answer any questions you may have.

Thank you.

APPENDIX A

98th CONGRESS
1st Session

H.R.________________

IN THE HOUSE OF REPRESENTATIVES

Mr. ____________ introduced the following bill; which was referred to the Committee on ____________

A BILL

To revise the status of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress Assembled

SECTION 1. The short title of this bill shall be the Savings Institutions Regulatory Improvements Act.

SEC. 2. Section 9101 of title 31, United States Code, is amended:

(a) in subsection (2) by redesignating paragraphs (G) through (J) as (I) through (L) respectively, and by adding the following two new paragraphs: "(G) the Federal Savings and Loan Insurance Corporation. (H) the Federal Home Loan Bank Board."; and

(b) in subsection (3) by striking out paragraph (E) and by redesignating paragraphs (F) through (M) as (E) through (L), respectively.

SEC. 3. Section 402 of the National Housing Act, as amended (12 U.S.C. 1725), is amended:

(a) in subsection (c), by striking, in the fourth sentence of paragraph (5) thereof, the words "governing the expenditures of public funds", and inserting in lieu thereof the following:", as now in effect or hereafter enacted, including without limitation any restrictions, statutory or otherwise, relating to personnel, or personnel employment levels, whether found in title 5 of the United States Code or elsewhere, or to apportionment of expense; and expenditures of the Corporation shall not be or be deemed to be from or of appropriations, appropriated amounts, or apportioned funds for the purposes of Title 31 of the United States Code or any other provision of law";

(b) in subsection (c) by striking the last sentence of paragraph (5) thereof and substituting therefor the following: "Notwithstanding any other provision of law, the Corporation is exempt from annual appropriation requirements and from budget review or approval by the Office of Management and Budget."; and (c) in subsection (d), by striking, in the second sentence thereof, (i) the words "in the Treasury" and substituting therefor the words "with the Treasurer of the United States in a special deposit account" and (ii) the period at the end thereof and substituting the words ", and shall be available, retroactively as well as prospectively, to be utilized by the Corporation for all purposes of the Corporation.".

SEC. 4. Section 19 of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1439), is amended:

(a) by striking out the period in the first sentence and inserting in lieu thereof the following: "without regard to any other provision of law, as now or hereafter enacted, including without limitation any restrictions, statutory or otherwise, relating to personnel or personnel employment levels, whether found in title 5 of the United States Code or elsewhere, or to apportionment of expenses; and expenses of the Federal Home Loan Bank Board shall not be or be deemed to be from or of appropriations, appropriated amounts, or apportioned funds for the purposes of Title 31 of the United States Code or any other provision of law";

(b) by amending the third sentence thereof by striking the words "in the Treasury of the United States and may be from time to time withdrawn therefrom to defray the expenses of the Board, and the salaries of its members and employees" and substituting therefor the words "with the Treasurer of the United States in a special deposit account and shall be available, retroactively as well as prospectively, to be withdrawn by the Board for expenditures for all purposes of the Board"; and

(c) by striking out the fourth sentence thereof.

SEC. 5. Section 7(b) of the First Deficiency Appropriations Act (15 U.S.C. 712a(b)) is amended by striking the phrases "1. Federal Home Loan Bank Board;" and "11. Federal Savings and Loan Insurance Corporation;".

SEC. 6. Section 11 of the Permanent Appropriations Repeal Act, June 26, 1934, ch. 756, 48 Stat. 1224, 1229, is hereby repealed.

SEC. 7. Section 9105 of Title 31, United States Code, is amended by striking the second sentence in paragraph (2) of subsection (a) thereof.

SEC. 8. Section 101 of the Independent Office Appropriations Act, 1944 (12 U.S.C. 1439a) is amended by striking out the phrase ", subject to subsections (a) and (b) of section 712a of Title 15" and by adding at the end of said section 101 the sentence "Notwithstanding any other provision of law, the Federal Home Loan Bank Board is exempt from annual appropriations requirements and from budget review or approval by the Office of Management and Budget.".

SEC. 9. Section 18(c) of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1438(c)), is amended:

(a) in paragraph (1) , in the first sentence thereof, by striking the phrase "and subject to any limitation hereon which may hereafter be imposed in appropriation Acts,";

(b) in paragraph (5) by striking out in the first sentence the phrase ", and obligations and expenditures of the board and such agencies in connection with this subsection shall not be considered as administrative expenses"; and

(c) in paragraph (6), (i) by deleting in the first sentence the phrase "(A) annually prepare and submit a budget program as provided in Title I of the Government Corporation Control Act with regard to wholly owned Government corporations, and for purposes of this sentence, the terms 'wholly owned Government corporations' and 'Government corporations', wherever used in such section, shall include the board, and (B)"; and (ii) by deleting in the second sentence the phrase "first budget program shall be for the first full fiscal year beginning on or after the date of enactment of this subsection, and the ".

SEC. 10. Section 1 of the Reorganization Plan No. 6 of 1961, 75 Stat. 838, is amended: (1) by striking out clause (6); and (2) by striking out in clause (7) the words "for administrative expense purposes".

SEC. 11. Section 5B of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1425b), is amended by deleting subsection (d).

SEC. 12. Section 201 of the Independent Offices Appropriation Act, 1961 (12 U.S.C. 1438a) is amended by deleting the phrase "Provided Further, That hereafter expenses of the Board in making studies or investigations specifically directed by law, or requested by the Congress or either House thereof or by a committee of either House, including services authorized by section 15 of the Act of August 2, 1946 (5 U.S.C. 55a), shall be considered as non-administrative expenses:".

SEC. 13. Section 19 of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1439), is amended by striking the last sentence thereof.

SEC. 14. Section 5(d)(9) of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1464(d)(9)), is amended by striking the last sentence thereof.

SEC. 15. Section 407(m)(3) of the National Housing Act, as amended (12 U.S.C. 1730(m)(3)), is amended by striking the second to the last sentence.

SEC. 16. Section 408(h) of the National Housing Act, as amended (12 U.S.C. 1730a(h)), is amended by striking out paragraph (6).

SEC. 17. Notwithstanding any language found in sections 3 or 4 of this Act, nothing in this Act shall be construed to exempt the Federal Home Loan Bank Board or the Federal Savings and Loan Insurance Corporation from the application of any federal law (in effect as of the date of the enactment of this Act) relating to personnel that is applicable to a Federal Home Loan Bank.

APPENDIX B

SECTION-BY-SECTION ANALYSIS

Section 1: Section 1 specifies that the bill's title is the Savings Institutions Regulatory Improvements Act.

Section 2: This section would provide the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation with "mixed-ownership government corporation" status. Such status, which already is enjoyed by the Federal Deposit Insurance Corporation and the Federal Home Loan Banks, would eliminate the need to observe a variety of requirements relating to obtaining budget approvals from the Office of Management and Budget and the Congress. Over time, these requirements have seriously reduced the ability of the Bank Board and the FSLIC to respond quickly and flexibly to the rapidly changing financial environment that shapes the exercise of their regulatory responsibilities.

Section 3: Section 3 would specify, first, that the FSLIC in spending money would not be bound by the normal federal agency requirements pertaining to such personnel-related matters as hiring, firing and compensation. This should prove extremely beneficial in terms of enabling the FSLIC to attract and retain the high quality employees it needs to perform its duties under the challenging circumstances now confronting it. In addition, section 3 would stipulate that FSLIC monies -- like those of the FDIC -- would not be regarded as being appropriated funds, and would not be subject to apportionment. Apportionment refers to a requirement that agencies must estimate what their expenses will be for each quarter of the coming year and obtain OMB approval before spending an amount in excess of the estimated sum. Further, this provision would make an explicit statement of exemption of the FSLIC from the appropriations process and from OMB budget review or approval. The non-appropriated-funds status of FSLIC monies would be reinforced further by a stipulation that such funds would be placed with the Treasurer of the United States in a special deposit account, rather than simply deposited in the Treasury, thus eliminating any possible conflict with the Constitutional admonition that funds are not to be withdrawn from the Treasury except pursuant to an appropriation. The amendment also would delete a reference to certain expenses of the FSLIC as being non-administrative, as opposed to administrative, expenses, a budgetary distinction that the Act would make obsolete.

Section 4: This section essentially would accomplish the same objectives for the Bank Board that Section 3 would for the FSLIC.

Section 5: This section would delete a requirement that Bank Board and FSLIC administrative expenses must be subject to the appropriations process.

Section 6: Section 6 would delete a provision stipulating that Bank Board assessments from the Federal Home Loan Banks shall be covered into the Treasury as miscellaneous receipts. According to Comptroller General Opinion A-62578, June 29, 1935, the provision effectively was repealed by Section 9 of the Act of May 28, 1935, which amended Section 19 of the Federal Home Loan Bank Act by saying that such assessments are to be deposited in the Treasury.

Section 7: Section 7 would delete a requirement that the Comptroller General audit the FSLIC and the FHLBanks on an annual basis, thus leaving the frequency of audits to the discretion of that official, subject to the general requirement that all government corporations must be audited at least once every 3 years.

Section 8: This section would eliminate a cross reference in the FHLBank Act to a provision the applicability of which to the Bank Board would be eliminated by section 5 of this bill. In addition, it would add to the FHLBank Act an explicit statement, basically identical to that which section 3 would add regarding the FSLIC, exempting the Bank Board from annual appropriations requirements and from OMB budget review or approval.

Section 9: Under Section 9, the Bank Board would be relieved of the requirement that it prepare an annual budget for OMB regarding the agency's building

	and facilities. This would not affect, however, the requirement that the Bank Board maintain records regarding such building and facilities for annual audit by the General Accounting Office. Section 9 also would eliminate two provisions in the FHLBank Act specifying the non-administrative nature of certain expenses.
Section 10:	Section 10 would strike a stipulation that the Chairman of the Bank Board is responsible for submitting a budget to OMB and justifying it to Congress. The section also would delete a reference to administrative expenses.
Section 11-16:	These sections would eliminate various provisions stating that certain Bank Board or FSLIC expenses are to be considered as administrative expenses or non-administrative expenses.
Section 17:	Section 17 would assure that the preemptive language employed in sections 3 and 4 with respect to personnel laws would not be construed to exempt the Bank Board or FSLIC from the application of, for example, federal anti-discrimination statutes; federal laws affecting personnel practices would continue to apply to the Bank Board and the FSLIC to the extent they applied to the FHLBanks.

APPENDIX C

U.S. LEAGUE SUPPORTS NEW ENFORCEMENT POWERS FOR BANK BOARD

In terms of protecting the FSLIC, the Bank Board is keenly interested in upgrading its arsenal of enforcement tools in order to enable it to deal more effectively with some of the problems generated by "high-flier" institutions. The League, after long and detailed deliberations, has agreed to support important statutory changes in this area.

TEMPORARY CEASE-AND-DESIST ORDERS

Of these increased powers, the U.S. League believes that enhanced temporary cease-and-desist order authority would be among the most useful. Under present law, a temporary C&D -- which is, in effect, an administrative injunction -- may be used only where a violation of law, rule or regulation or an unsafe or unsound practice exists that could cause insolvency or substantial dissipation of assets or earnings, seriously weaken the condition of the insured institution or seriously prejudice the interests of its insured members. An institution facing such an order may contest it in U.S. District Court within 10 days of issuance; otherwise, the order remains effective until the underlying issues are adjudicated administratively.

The Bank Board, in its Insured Institutions Improvements Act, S. 759, is seeking to eliminate "substantial" and "seriously" as modifiers of the terms dissipation and weaken, respectively. The League has determined that we can support this, subject to several conditions. First, such orders should be in effect only for 60 days, after which the current standard would have to be met. We believe this would give the agency adequate time to deal with emergency situations with what amounts to the free hand available in the temporary order context, without substantially compromising the general principle that injunctive-style relief requires the meeting of very significant initial standards (e.g. irreparable injury).

Second, this extraordinary new authority would be subject to a 2-year sunset provision. This would provide Congress with an opportunity to assess, within a relatively short time frame, the manner in which the new authority had been exercised by the supervisory authorities.

Third, procedural safeguards should be implemented to ensure full review of relevant files by the Principal Supervisory Agent and the General Counsel, with the opportunity for an informal plea (absent emergency conditions) to the Bank Board members by the target prior to issuance of such an order, with access by the target to the staff memo requesting the order. These safeguards are designed to underline the fact that the new temporary order is not something to be employed without the most serious review and consideration.

The League also has elected to support the Bank Board in its effort to obtain an additional temporary order that would allow the Bank Board to require cessation of any action the agency deemed appropriate if, because of incomplete or inaccurate records, the agency, after reasonable effort, was unable to determine an institution's financial condition. While we believe the above procedural safeguards should apply to record-keeping temporary orders as well, the League does not believe a sunset provision to be necessary, in light of the central and paramount importance of complete and accurate records to the supervision of our system of federally-insured depository institutions.

CEASE-AND-DESIST AUTHORITY

The Bank Board is also seeking to have persons filing (or required to file) a Change in Savings and Loan Control Act notice, and subsidiaries of service corporations added to the list of entities against which C&D orders (or temporary C&D orders) could be issued. In addition, orders could be issued against individuals who have resigned from a potential target organization and against an insured institution (or related individuals or an affiliate) during the two-year period after termination of insured institution status during which an institution still has insured accounts. The U.S. League has no objection to these proposals, provided the ability to obtain C&D orders against individuals who have resigned lasts only for two years after resignation. We believe this would represent a reasonable statute of limitations.

REMOVAL/PROHIBITION AUTHORITY

In addition to proposing increased temporary and standard cease-and-desist order authority, the Bank Board has requested greater removal and prohibition power, as well.

At present, removal/prohibition actions may be mounted against any officer or director of an insured institution, its service corporation or its holding company (or any subsidiary thereof) where, _inter alia_:

(1) there was (a)(i) a violation of a law, rule, regulation or cease-and-desist order which has become final;

(ii) an unsafe or unsound practice; or

(iii) a breach of fiduciary duty; and as a result,

(b)(i) the organization has suffered, or probably will suffer, substantial financial loss or other damage;

(ii) the interests of its insured members could be seriously prejudiced; or

(iii) the individual has received financial gain as a result of his conduct; and

(c) the conduct involved personal dishonesty, or has demonstrated or a willful or continuing disregard for the safety or soundness of the organization; or

(2) there was (a) conduct with respect to another business organization that resulted in substantial financial loss or other damage; and

(b) the conduct involved personal dishonesty or a willful or continuing disregard for the safety and soundness of the institution; and

(c) there is evidence of the individual's unfitness to continue as an officer or director.

Under the Bank Board's proposal, the "substantial" and "seriously" modifiers would be dropped from #1(b) and #2(a), breach of "professional duty" would be added to and equated with breach of fiduciary duty in #1(a), and receipt of financial gain would be added in #2(a) as the equivalent of loss to the employer. In addition, removal/prohibition actions could be taken against any person against whom a cease-and-desist order could be issued (subject, of course, to different criteria) and during the same period of time.

The League must decline to support the Bank Board's proposed elimination of "substantial" and "seriously" as modifiers, respectively, of the financial loss or prejudice to insured members' criteria, or its desired equation of breach of professional duty with breach of fiduciary duty as a removal criterion. The current removal standards generally seem suited to the seriousness of the penalty, and the League believes the weakening of those standards envisioned by the Bank Board would be inappropriate. In addition, we believe the concept of breach of professional duty is far too ambiguous for employment in the removal/prohibition context. The League supports, however, the Bank Board's proposed expansion of the list of potential removal/prohibition order targets, as well as the equation sought by the agency of receipt of financial gain with loss to the employer.

AUTHORITY TO SEEK INJUNCTIONS

At present the Bank Board basically is required to seek correction of unsafe or unsound practices or violations of law or regulation through a procedure that permits recourse to the courts only upon appeal from the agency's final administrative adjudication of the matter. As part of its enforcement proposal, however, the Bank Board is seeking authority to go into U.S. District Court to obtain injunctions against such violations of unsafe or unsound practices when it determines that its administrative enforcement provisions are insufficient to resolve adequately the situation.

The League understands the Bank Board's desire to have a broad variety of rapid-acting enforcement tools, but we cannot support granting the agency a direct judicial injunction option. We believe the adverse publicity that necessarily would be associated with public court battles over Bank Board requests for equitable relief inevitably would be damaging to public confidence, not just in the target institution, but in other associations as well. Moreover, given the substantial increment of temporary C&D power -- which essentially is injunctive power -- that the Bank Board is seeking and that the U.S. League is willing to support, we fail to see any real need for placing this additional tool at the Bank Board's disposal.

CHANGES IN CONTROL

In our view, one of the key aspects of the Bank Board's request for additional enforcement authority is its inclusion of provisions designed to give the agency more power to scrutinize changes in control. Essentially, the Bank Board is asking for enhancement of its definitional power regarding key terms -- such as "control" and "acting in concert" -- used in the Savings and Loan Holding Company Amendments of 1967 and the Change in Savings and Loan Control Act. The League strongly supports the Bank Board's efforts to gain more authority to pass upon the suitability of those persons and organizations wishing to acquire control of FSLIC-insured institutions.

UNSAFE OR UNSOUND PRACTICES

Another component of the Bank Board's enforcement package that the League supports involves a codification of the definition of the term unsafe or unsound practices. Such practices, currently statutorily undefined, would be defined as encompassing "any action or omission which is, in the opinion of the [FSLIC], contrary to generally accepted standards of prudent operation, whether relating to the association's internal management or to any external matter, the possible consequences of which, if continued, may pose abnormal risk of loss or damage to an insured institution or any subsidiary thereof, to its stockholders or accountholders or to the [FSLIC]."

Basically, this would incorporate into the statute, with some modification, explanatory language from a 1966 memorandum from then Bank Board Chairman John Horne to Congress regarding the meaning of the term unsafe or unsound practices. This memorandum is part of the legislative history of the Financial Institutions Supervisory Act of 1966, and at present represents the most authoritative definition of that term. Although, as noted, the League supports this definition, we urge that the legislative history of the proposed codification include language clearly indicating that, regarding external matters, it is not Congress' intent to have prudent managers classified as committing unsafe or unsound practices when they are victimized by conditions beyond their control, such as high interest rates.

INVESTIGATIVE AUTHORITY

A further feature of the Bank Board enforcement package that the U.S. League can support is its improvement of investigative authority. S. 759 would provide that entities that no longer have FSLIC insurance or that no longer are affiliated with FSLIC-insured organizations could be investigated by the Bank Board with regard to conduct that occurred when they were so insured or affiliated. This strikes us as a reasonable increment of authority that would help the agency better carry out its enforcement responsibilities.

SUBPOENA ENFORCEMENT

A final enforcement tool the League endorses involves the consequences of failure to obey a Bank Board subpoena. Under S. 759, failure, without just cause, to comply with a Bank Board subpoena would be made a misdemeanor punishable, upon conviction, by a fine of not more than $1,000 and/or imprisonment for a term of not more than one year. Again, we believe this is a reasonable provision that materially would assist the Bank Board in its enforcement efforts.

APPENDIX D

AN ANALYSIS OF THE OPERATION OF AND NEED FOR THE NET WORTH CERTIFICATE PROGRAM

The U.S. League strongly urges the Congress to extend the net worth certificate program due to expire in October of this year. It is only in the last few months that interest rates have declined to a level that affords a real opportunity for the business to restructure and it will take some years before the majority of savings institutions will be in a position to live through a period of high interest rates without suffering significant losses. If interest rates remain low, the net worth certificate program would be relatively costless. If rates were to increase sharply, the certificate program would be an inexpensive way of helping the business weather the high rate period. If the program were allowed to expire, it would take time for Congress to reenact were it needed and the crisis atmosphere that such an effort would entail would further undermine a public confidence that has already been eroded by the difficulties at some large financial institutions and the problems with some of the state savings institution insurance funds.

So far, 94 FSLIC-insured savings institutions have participated in the program and the FSLIC has purchased a total of $129.6 million in net worth certificates. At this stage, no "real money" has been spent in the program since there is no cash involved in the transaction unless an institution has to be liquidated.

Of the 94 institutions, the League's Research Department has been able to identify 89 on the FHLBB's quarterly-report databank -- the others having merged out of existence. The 89 institutions had total assets of $23 billion at the end of last year. If these institutions had to be liquidated instead of being supported by the net worth certificate program, the total cost would have been $3.7 billion, using the 16%-of-assets cost figure that is frequently used in such instances. Given the fact that the FSLIC had total reserves of only $6.9 billion at the end of last year, $3.7 billion is an impressively large figure.

The number of institutions using the program is small but there are particular reasons why more did not elect to participate.

The Bank Board in office when the program was instituted was inimical to it. The general counsel for the Board at the time is quoted by the General Accounting Office as saying:

> "There should be every incentive for institutions not to participate in the program, or if they do . . . to graduate from it as quickly as possible. Therefore, participants should expect a certain degree of increased regulatory restraints and general operating discomforts."

At least in the beginning, the Bank Board made it difficult for institutions to participate. In particular, in the first four months after it started the program, the Board received 95 applications but only acted on 13 of them -- and of those, only four were approved and the others were either withdrawn or denied. Since interest rates were declining and conditions were beginning to improve in the industry, thereby reducing the need for institutions to get involved, the early delays were probably extremely important in keeping the number of participating institutions at a low level.

The processing delays resulted from two of the Bank Board's administrative requirements -- approval of institutions' appraised equity capital and submission of business plans as conditions of assistance. Neither of these requirements were set as conditions by the statute. According to a 1984 GAO report:

> "When institutions first began submitting required property appraisals, . . . Federal Home Loan banks began rejecting them for technical reasons. Some appraisals were rejected because they did not reflect highest market value according to Bank Board criteria; some applications were delayed because of confusion about when business plans were required -- before or after assistance was granted -- and about their content."

In addition to being an administrative headache, the requirement to recognize appraised equity capital before an institution was allowed to issue net worth certificates disqualified 125 institutions according to GAO estimates because it took them over the threshold 3% net worth ratio.

Furthermore, the Bank Board, in the beginning, was more miserly than the FDIC in the amount of assistance it would grant. When an institution first entered the program the Board would purchase only half of the certificates the institution was entitled to under the statute.

Also the act suggests that the agencies cover 70%, 60% or 50% of an institution's losses depending on whether the institution had a 1% , 2% or 3% net worth ratio, respectively.

The Bank Board interpreted this to mean that it would first cover 70% of the losses up to the point at which it would bring the net worth, after assistance, to 1%. Then it would cover 60% of any remaining losses until the net worth ratio reached 2%. Finally, it would cover any more losses at 50% but only up to the point where the institution's net worth reached 3%.

According to the GAO, the Bank Board's assistance formula:

> "compared to the assistance allowed by the act's formula and available under FDIC's program, tended to decrease the amount of assistance available to qualified institutions. The act does not provide for the tiering calculation, nor for capping assistance at 3 percent net worth. FDIC, while capping assistance at 3 percent net worth level, does not use a tiering calculation when determining assistance amounts."

Under the chairmanship of Edwin Gray, the Federal Home Loan Bank Board liberalized the program. In September 1984, the Board eliminated the reduced initial assistance formula and the tiering calculation. The new formula provides for assistance at the maximum 70% suggested by the act with a cap at the 3%-of-assets net worth level.

In a new July 1985 report, the GAO found that the Bank Board and the FDIC were operating the programs in a manner that followed the intent of Congress:

> "We saw no indications of either agency departing from established statutory and regulatory eligibility criteria. Thus, we concluded that each agency was consistently applying its own eligibility requirements in granting thrifts net worth certificate assistance."

In the July report, the GAO pointed out that institutions that are receiving net worth certificates continued to lose money in 1984 while the business as a whole was profitable. The business, in the aggregate, was profitable in 1984, though only barely so. The return on assets for the year was only 0.14% and almost one-third of the industry was still losing money in the first quarter of 1985. Thus, it should not be surprising that institutions that were weak enough to qualify for assistance in the first place were still showing losses in 1984. Furthermore, the 89 institutions that we have been able to trace made considerable progress in reducing their loss levels throughout the year. The aggregate annualized quarterly return on assets was as follows:

First Quarter, 1984	-0.80%
Second Quarter, 1984	-0.32%
Third Quarter, 1984	-0.59%
Fourth Quarter, 1984	-0.28%

Also 14 of the 89 institutions made money in the first quarter last year and, by the fourth quarter, 31 were in the black.

For the business as a whole, our preliminary results show that the second quarter of 1985 showed a strong pick-up in profitability levels. We would suggest that the second quarter results are the ones to look at for the institutions that are in the net worth certificate program if one is trying to determine their ability to return to profitability.

In May of 1985, the GAO released, without comment, a series of tables comparing institutions that have received net worth certificates with the business as a whole. One of these tables shows that the portion of assets in the form of fixed rate mortgages fell from 77.0% to 61.3% between December 1982 and September 1984 for those institutions receiving assistance. This decline of 15.7 percentage points compares with a decline of 18.9 percentage points for the business as a whole, where fixed rate mortgages fell from 72.1% to 53.2%.

Similarly, the percentage of assets in the form of ARMs for assisted institutions rose from 3.2% to 17.2% compared to a rise from 6.8% to 21.9% for all institutions. Although the GAO does not explicitly say so, one presumes that these figures are presented to show that institutions receiving net worth certificates are making less progress towards restructuring than the average institution. Again, these findings are not surprising. Many of the assisted institutions are located in areas where the real estate market is not as buoyant as in other areas and the fact that they have made only a little bit less progress in restructuring than the rest of the business argues on behalf of the continuation of the program.

In sum, it would appear very beneficial for the Congress to renew the program. It gives the regulators additional flexibility in dealing with problems, particularly the problems that would arise if interest rates were to climb again. It does not reduce the regulators' authority and flexibility in disposing of problem cases if the opportunity to do so exists. In fact, one of the explicit requirements of the Bank Board that must be met before an institution can issue net worth certificates is that a merger that would reduce the need for assistance is not available.

Chairman ST GERMAIN. Thank you.

We will now hear from George P. Rutland, who appears on behalf of the National Council of Savings Institutions. You're the biggies, right?

STATEMENT OF GEORGE P. RUTLAND, VICE CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CALIFORNIA FEDERAL SAVINGS & LOAN ASSOCIATION, LOS ANGELES, CA, ON BEHALF OF THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Mr. RUTLAND. I don't know if you could categorize us that way, but we're 600 of us.

Mr. Chairman and members of the committee, my name is George Rutland. I am vice chairman and chief executive officer of the California Federal Savings & Loan Association of Los Angeles, and I'm appearing today in my capacity as chairman of the task force on alternatives to reregulation, established by the National Council of Savings Institutions in May of this year.

In the interest of time, I will not comment on all of the items in my written statement, but only on certain ones that we think should be emphasized.

As the principal insurer of the Nation's thrift institutions, the Federal Savings and Loan Insurance Corporation has had to confront an unprecedented proportion of problem institutions since the early 1980's. Many cases had to be resolved with FSLIC financial assistance and FSLIC's resources have been reduced dramatically over the last few years.

Not only is the FSLIC threatened by these circumstances but well-managed, profitable members of the industry are also affected by the weaker institutions. We have a situation today in which the FSLIC is confronted with a substantial number of institutions operating with a thin capital base that creates an incentive for management to make even riskier investments.

The response of the Federal Home Loan Bank Board to this changeover from dealing with spread problems to asset problems has been to embark on a course that can only be described as reregulating the industry.

Accordingly, the Council established an industry task force to study alternatives to reregulation, and I would now like to summarize our major recommendation in this area.

First, the task force recommends a risk-based capital requirement as a step in the same general direction as risk-based premiums of providing protection for the insurance funds against excessive risk-taking by insured institutions, but one which can be taken by the FSLIC under existing authority.

Second, examination and supervision linked to risk-related net worth requirements. At present, the Federal Home Loan Bank System requires that its members file extensive quarterly reports and subjects them to a full, on site examination once during a 36-month cycle, with more limited examinations every 12-24 months.

In order to decrease the incidence of problem cases, the task force proposes to scale reporting and examination frequencies by levels of risk-base required net worth. Well-capitalized institutions will be subjected to current reporting and examination rules. As an institution drops below its required net worth level, examination frequency and scope should dramatically increase.

The Federal Home Loan Bank Board has already taken steps to solve the compensation and recruiting problem by decentralizing the function to the 12 district banks.

Third, handling of insolvent institutions. The task force recommends the establishment of a special purpose corporation or corporations in each of the Federal home loan bank districts for the purpose of handling insolvent, FSLIC-insured institutions. And, as part of this step, a specific time schedule of events and actions should be followed in dealing with institutions approaching insolvency.

The initial steps necessary to establish this corporation, as you know, are already underway at the Federal Home Loan Bank Board.

The operating strategies would be to: No. 1, convert portfolio assets, including real estate, into cash, with new lending prohibited except for the purpose of recovery of specific existing assets; No. 2, replace high cost deposits with lower cost funds; and No. 3, sell branch systems and other assets.

We believe that these corporations should be financed, at least in part, through the home loan banks. We believe that the foregoing represents a balanced, well-reasoned and comprehensive approach to strengthening the FSLIC. It emphasizes private sector involvement and can be implemented immediately under existing authority without further legislation.

Those are my comments; they are brief, but our written statement carries much more detail.

Thank you.

[The prepared statement of Mr. Rutland on behalf of the National Council of Savings Institutions follows:]

FEDERAL DEPOSIT INSURANCE REFORM

Statement of

George P. Rutland
on behalf of the
National Council of Savings Institutions

before the

Subcommittee on Financial Institutions Supervision,
Regulation and Insurance
of the
Committee on Banking, Finance and Urban Affairs
U. S. House of Representatives

Room 2128 Rayburn House Office Building
October 3, 1985
10:00 a.m.

Mr. Chairman and distinguished Members of the Subcommittee my name is George P. Rutland, Vice Chairman and Chief Executive Officer of the California Federal Savings and Loan Association, Los Angeles, California, an $18 billion savings institution. I am appearing today on behalf of the National Council of Savings Institutions, a trade association consisting of approximately 600 savings banks and savings and loan associations with total assets in excess of $430 billion. Our members include both FDIC- and FSLIC-insured depositories; the Council also represents approximately 50 banks located primarily in the State of Massachusetts which are state insured but are now in the process of obtaining federal coverage.

We are very pleased to accept your invitation to testify on the state of the deposit insurance system. This is a timely subject not only insofar as the industry and its regulatory agencies are concerned, but one which is also very much on the mind of the general public. Last year we witnessed the near collapse of two of the nation's very largest financial institutions, namely Continental Illinois National Bank and American Savings and Loan, the thrift subsidiary of Financial Corporation of America. In 1985 we have seen no abatement in the number of well-publicized problem institutions, including large money center banks, small agricultural banks and thrift institutions of all sizes.

Because the current wave of individual bank and thrift failures has coincided with the industry deregulation mandated by federal legislative and regulatory initiatives launched in the late 1970s, many observers have mistakenly concluded that deregulation is the culprit. We believe that a closer examination of the evidence would show that the preponderance of recent problems have been caused not by the use of newly acquired powers, but by the abuse or imprudent use of long-standing powers. In this regard, the Council concurs fully with the findings of the study which Dr. George Benston presented to the Subcommittee yesterday. Our prior research on the real estate investment experience of savings banks showed similar results, i.e., prudent and profitable use by depository institutions.

INDUSTRY OVERVIEW

Because public attention has focused on the handful of problem cases, I want to begin by taking just a moment to stress that insofar as the performance of the vast majority of thrift institutions is concerned, deregulation is not only working but working well. This is not to say that the transformation to the more competitive banking environment of the 1980s has been an easy one for the industry. Cost-cutting, product realignment, controlled growth, and portfolio restructuring have been the key elements of success in recent years and, as we have seen, management is not in place at every institution to accomplish these difficult tasks.

In large part, the problems which have been encountered are due to the fact that, for thrift institutions, deposit deregulation preceded asset deregulation. Indeed, the repricing of deposits in the first several years of deregulation took place in an environment of record high interest rates and has proceeded throughout a period in which the cost of funds has remained relatively high on an historical basis. Earnings and capital positions at thrift institutions were severely eroded over the period of the last five years, and meaningful progress in rebuilding net worth has really only been possible, on an across-the-board basis, during the last 18 months.

I am glad to report, however, that conditions have now improved to the point where the National Council's Research Department estimates that savings banks earned nearly $500 million in the first half of 1985, and added $214 million to surplus in the month of July alone. Virtually all savings banks operated in the black during the third quarter of 1985, and this is the first time that this has been the case since 1979. The lower interest rate environment has also permitted a growing number of institutions to go to the capital markets for stock conversions and other financial offerings. This combination of retained earnings and new stock offerings has resulted in a marked improvement in industry capital:

CHART I

Annualized Net Change in Savings Bank Surplus
as Percentage of Average Assets, Quarterly

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Calendar Year
1985	.30%	.40%	.40%p		
1984	**	-.12	.16	.29%	.08%
1983	-.04	.32	.17	.15	.15
1982	-.92	-.88	-.64	-.35	-.86
1981	-.48	-.76	-1.08	-1.20	-.86
1980	.28	.40	-.32	.04	-.10
1979	.68	.56	.44	.24	.47
1978	.60	.72	.56	.40	.57
1977	.60	.60	.56	.44	.55
1976	.40	.44	.56	.36	.44
1975	.32	.40	.44	.36	.38

p = preliminary, based on July 1985 data
** = Less than .005 percent.

Note: Data refer to net changes in surplus, undivided profits, reserves from retained earnings and exclude debentures, capital infusions from FDIC, net worth certificates and net stock issues.

On the savings and loan side, the overall picture is likewise very positive insofar as total earnings are concerned, although there continue to be approximately 20% of the industry which is not participating in the industry turnaround. This is due primarily to problems relating to loan quality as opposed to a maturity mismatch between assets and liabilities which has traditionally been at the core of thrift industry difficulties. Notwithstanding these individual exceptions, we estimate that 1985 will be a record year for savings and loan profits, and that the industry will also make substantial strides in rebuilding its net worth.

CHART II

Retained Earnings as Percent of Total Assets of Savings and Loans 1975-1985

Year	Percent
1975	0.47%
1976	0.63
1977	0.77
1978	0.81
1979	0.67
1980	0.13
1981	-0.73
1982	-0.64
1983	0.27
1984	0.15
1985p	0.34

p = preliminary, based on June 1985 data

MEMBERSHIP IN DEPOSIT INSURANCE FUNDS

State Systems

Thrift institutions have basically had three alternatives for deposit insurance: FDIC; FSLIC, and state-sponsored private insurance funds. The largest private funds are in Massachusetts where both savings banks and cooperative banks (S&Ls) have participated in a state-sponsored system which actually predates the establishment of the FDIC and FSLIC. Other states where savings and loan associations may be insured under private plans include Maryland, North Carolina, Ohio and Pennsylvania. In California and several other states there has also existed a private deposit insurance alternative for industrial banks and thrift and loan associations.

These private state funds are in the process of reorganizing inasmuch as their insured institutions in almost all instances have applied for federal deposit insurance in the wake of the Maryland and Ohio banking crises. The FDIC and FSLIC are processing these applications as best as can be done under the circumstances. The latest data we have been able to develop on the insurance status of thrift institutions show that nonfederally insured institutions have declined from 750 in 1980 to 365 in 1984, to 149 at the present time. At least another 100 of these remaining institutions have already applied for federal coverage, and thus it seems clear that the private deposit insurance option will become a thing of the past for thrift institutions as well as the other types of depositories which I have mentioned.

CHART III

Thrift Institution Membership in Deposit Insurance Funds, 1945-1985

Year	Total Thrifts	FDIC	FSLIC	State and Other
1945	6,595	192	2,475	3,928
1950	6,439	194	2,860	3,385
1960	6,822	325	4,098	2,399
1970	6,162	329	4,365	1,468
1980	5,076	323	4,002	751
1981	4,740	331	3,779	630
1982	4,249	315	3,343	591
1983	3,912	245	3,183	484
1984	3,774	242	3,167	365
1985p	3,716	283	3,284	149

p = preliminary, based on June 1985 data.

On this point, your invitation to testify specifically asked us to comment on the role for private insurance. As I have indicated, market forces have already addressed the question of private insurance systems functioning as an exclusive alternative to federal insurance. However, it would be our hope that private insurers could continue to play an important supplemental role either as reinsurers or as insurers of deposits in excess of federal coverage. This latter approach has worked well in Massachusetts where depositors have 100% of their funds insured through a combination of the federal government handling amounts up to $100,000 per account and the state system the remainder.

FDIC

The Federal Deposit Insurance Corporation has been responsible since its creation in 1933 for insuring savings banks. At this time the FDIC insures 283 stock and mutual savings banks with approximately $184 billion in total assets. Over the last five years the FDIC has devoted considerable time and resources to problems associated with the thrift industry, particularly those savings banks which were most severely impacted by the adverse interest rate climate. There have been 15 FDIC-assisted supervisory mergers involving savings banks since 1980, and in most cases the problem institutions were merged into other savings banks.

In addition, 30 savings banks have participated in the Net Worth Assistance Program established by the FDIC pursuant to the Garn-St Germain Act of 1982. Mergers have been arranged for seven of these institutions which leaves 23 still participating in the program. All but one of these institutions are now operating in the black. The remaining institution has also made substantial progress and has recently received the regulatory clearances to proceed with a major recapitalization by private investors that will complete the turnaround at that bank. Indeed, three of the participating institutions have begun to retire their net worth certificates ahead of schedule, and a number of others are expected to follow shortly. There is no question that the Net Worth Assistance Program has resulted in major cost savings to the FDIC thereby justifying an extension of the program beyond its scheduled October 15, 1985, expiration date.

Since the height of the thrift crises in 1982, the focus of the FDIC's problem institutions has, of course, shifted from savings banks to commercial banks. As a matter of fact, the $4.5 billion of financial assistance which the FDIC extended to Continental Illinois National Bank is twice that which has been devoted to the entire savings bank industry over the course of 50 years. Were it not for the cost savings realized by deferring action on the problem thrifts by virtue of the Net Worth Assistance Program, a good case could be made that the FDIC would not have been nearly as capable of handling the Continental rescue, the rising failure rate among agricultural banks, and the continuing threat of new financial strains relating to delinquent and/or deferred foreign loans.

Nevertheless, the FDIC has substantial reserves and a steady stream of income from both commercial and savings banks that should permit it to handle all of these potential problems while remaining in strong financial shape. We generally support the reforms which Chairman Isaac has requested in his proposed legislation, H.R. 1833, although we believe that many important remedial steps such as varying rebates and capital requirements in relation to risk, can be effectively implemented without waiting for additional legislation.

FSLIC

As the principal insurer of the nation's thrift institutions -- approximately 2,800 S&Ls and 400 federal savings banks -- the Federal Savings and Loan Insurance Corporation has had to confront an unprecedented proportion of problem institutions since the early 1980s. During the period of the last five years, approximately 1,000 FSLIC-insured thrift institutions disappeared either through merger, purchase and assumption, or liquidation. Many cases had to be resolved with FSLIC financial assistance and, FSLIC's resources have been reduced dramatically over the last few years.

Not only is the FSLIC threatened by these circumstances, but well-managed, profitable members of the industry are also affected by the weaker institutions. Failing institutions have little incentive to keep costs down by pricing their deposits reasonably. On the asset side, these institutions may underprice their loans or, worse yet, scramble to put high yielding assets on their books without sufficient regard for proper underwriting standards. Thus, we have a situation today in which the FSLIC is confronted with a substantial number of institutions operating with a thin capital base that creates an incentive for management to make even riskier investments.

The response of the FHLBB to this changeover from dealing with "spread" problems to asset problems has been to embark on a course that can only be described as reregulating the industry. The National Council fully appreciates the monumental problems now facing FSLIC and its parent agency the FHLBB, but we are gravely concerned about this course of action which amounts to regulating to the lowest common denominator. Accordingly, the Council acted last May to establish an industry Task Force to study "Alternatives to Reregulation", which it has been my privilege to chair.

This Task Force will be examining a broad range of issues, but its initial focus has been on proposed actions to strengthen the FSLIC. In this regard the task force has benefited substantially from the input of David W. Glenn, a former FSLIC director, who now works at Cal Fed. I would now like to summarize the major recommendations of the Task Force in the FSLIC area.

I. Risk-related net worth requirements.

The National Council has officially supported risk-based deposit insurance premiums provided that risk is objectively determined. Moving to a risk-based insurance premium system, however, would require legislation. Accordingly, the Task Force recommends a risk-based capital requirement as a step in the same general direction of providing protection for the insurance funds against excessive risk-taking by insured institutions, but one which can be taken by the FSLIC under existing authority. An additional advantage is that increased capital would strengthen both the institution and the insurance fund. Under the Task Force's plan, higher-risk institutions would be required to have capital ratios above the base requirement applicable to FSLIC-insured institutions generally.

In measuring risk, the focus should be on the entire institution and should seek to rate each institution as a whole in terms of the risk it poses to FSLIC. The system should encompass all types of risk (interest-rate, asset quality, managerial, etc.). It should not be based on whether the institution utilizes powers granted at the state or federal levels, but on the performance and soundness of the institution as a whole.

Examples of the "institution as a whole" approach are the CAMEL ratings (capital, asset quality, management, earnings and liquidity) used by the bank regulators and the broadly similar MACRO ratings used by FHLBB for general supervisory purposes. In utilizing this approach to measure risk for purposes of setting capital requirements, however, ratings for individual institutions should be determined as objectively as possible, using actual experience and "hard" data (balance sheet structure, earnings trends, loan delinquencies, etc.) as well as examiners' evaluations.

Institutions rated as riskier under the approach recommended by the Task Force would be required to have higher net worth in relation to assets. If existing net worth is below that standard, the institution would be subject to the following strictures: (1) the institution would automatically be subject to increased and intensified examination at its own expense; and (2) the institution would be required to submit a business plan indicating how it intends to reduce its risk exposure and/or increase its net worth. Progress in achieving these goals would be carefully monitored.

In addition, immediate action would be taken against institutions not meeting their net worth requirements to prevent such institutions from pricing deposits outside of their peer group rate structure. Ultimately, failure to move toward an improved risk-capital relationship or any deviation from the controls placed upon them would expose the institution to cease and desist or removal actions by the regulator. In this respect, as well as in other cases where the situation warrants, the Task Force urges full use of the Bank Board's enforcement authority, which is more than adequate under existing law.

The Task Force recommends that the Bank Board promptly establish a special advisory group which would be charged with the responsibility of developing within 6 months a risk-related net worth requirement based on the "whole institution" approach outlined above. The special advisory group would include industry trade association representatives, insurance experts and other consultants. Formation of such a group would be consistent with the Bush Task Group's recommendation that maximum use of private sector expertise be utilized in developing risk-measurement techniques and Chairman Gray's expressed suggestion that private sector groups make objective and impartial risk pricing recommendations to the Bank Board.

II. Examination and supervision linked to risk-related net worth requirements.

At present, the Federal Home Loan Bank System requires that its members file extensive quarterly reports, and subjects them to a full, on-site examination once during a 36-month cycle, with more limited examinations (usually confined to particular functions such as lending standards or futures and forward transactions) on an annual basis. The examination will focus on any of the number of aspects of the association's activities, but will result in a MACRO rating (similar to the CAMEL rating employed by the FDIC) from 1 to 5 that will measure the risk of the institution as reflected in its net worth, earnings, and asset quality.

Institutions failing to meet their net worth requirements are subject to more frequent examination, usually on an annual basis. These institutions are also subject to monthly computer monitoring of certain ratios that have been identified by Kaplan Smith and Associates (under contract to the Bank Board) as identifiers of impending trouble. Unlike the FDIC system, however, these institutions are not always required to file business plans or other such devices aimed at laying out the path the firm will take toward reaching minimum capital levels.

In order to decrease the incidence of problem cases, the Task Force proposes to scale reporting and examination frequencies by levels of risk-based required net worth. In general, well-capitalized institutions will be subjected to current reporting and examination rules, with each examination focusing on several specific aspects of the thrift's operations. As the institution drops below its required net worth level, examination frequency and/or scope will increase, with most intensive monitoring applied to those with negative net worth. One possible schedule is as follows:

Level 1: Associations with RAP net worth above that required. Semiannual reporting forms will be required with examinations on the regular 36-month cycle and no limited examinations.

Level 2: Associations with net worth within one per cent below risk-adjusted requirement. Quarterly reporting will be maintained, but full examinations will take place on a 36-month cycle, and limited examinations on a 24-month cycle.

Level 3: Associations with net worth between 1 and 2 percent below requirements. Reports will be submitted quarterly with annual examinations. In addition, monthly computer monitoring of sensitive variables will be maintained.

Level 4: Associations with net worth 2 or more percent below requirements. Reports will be submitted monthly, with semiannual examinations. In addition, monthly computer monitoring of sensitive variables will be maintained.

Level 5: Associations with negative net worth. Monthly examinations; the association will not be allowed to make any significant investment or growth decision without the specific approval of the supervisory agent.

In line with the Task Force's previous recommendation, each institution in levels 2, 3, 4 and 5 would be required to submit a business plan indicating how it intends to increase its net worth and/or reduce its risk exposure.

For state-chartered institutions at Levels 1 and 2, state examinations should be allowed to substitute for federal examinations at the discretion of the federal regulator. This would have the effect of conserving FHLBB staff resources and allowing more attention to be focused on problem institutions. In the case of Levels 3, 4 and 5, the examinations would be comprehensive and aimed at ascertaining compliance with, and progress toward accomplishing the goals set forth in the business plan.

III. Accounting issues related to net worth.

The Task Force recommends that FHLBB regulatory accounting principles continue to be used in the proposed FHLBB net worth and examination schedules. The use of regulatory accounting principles is appropriate in setting regulatory requirements. Publicly-traded institutions will, of course, be subject to GAAP in published financial statements.

IV. Handling of insolvent institutions.

The Task Force recommends: (1) the establishment of special purpose corporations in each Federal Home Loan Bank District for the purpose of handling insolvent FSLIC-insured institutions; and (2) a time schedule of events and actions which should be followed in dealing with institutions approaching insolvency. The general objective is to reduce costs to FSLIC by establishing a new mechanism for the disposition of problem cases as well as for the earlier resolution of these cases. We are very encouraged that the initial steps necessary to establish this corporation are already underway at the FHLBB.

As we envision it, these corporations would be chartered, as needed, in each Home Loan Bank District pursuant to the authority now contained in Section 406 of the National Housing Act. Their directors would be appointed by the respective District Banks and would, in turn, appoint the management of the companies. The directors and managers would be covered by FSLIC indemnification agreements as under the current management consignment program. The function of these corporations would essentially be to manage the orderly least-cost disposition of the assets and liabilities of

FSLIC-insured institutions for which no merger partners or acquirers can be found, which have been declared insolvent and which have gone into receivership.

The Task Force believes that establishing a corporation in each of the twelve Districts would be preferable to a single corporation serving the entire nation. The Task Force's approach would encourage the broadest possible participation in the affairs of these corporations. Each corporation, working with the District Bank in its area, would have better knowledge of local institutions and local market conditions. Decentralization of the liquidation function in this manner would be consistent with the decentralization of the examination function which has already been accomplished by the Federal Home Loan Bank Board.

The operating strategies in each instance would depend on the circumstances. The emphasis, however, would be to: (a) convert portfolio assets including real estate into cash (new lending would be prohibited except for the purpose of recovery of specific existing assets); (b) replace high-cost deposits with lower-cost funds; and (c) sell branch systems and other assets. We believe that these corporations should be financed, at least in part, through the Home Loan Banks (including FSLIC-guaranteed borrowings) at the lowest cost (i.e. non-penalty rates) and with market borrowings guaranteed by the District Banks and/or FSLIC. In the current climate, the cost of such funds would be lower than that of deposits.

Before an institution is put in the hands of the special purpose corporation, every effort to find a merger partner or acquirer should be conducted. A time schedule, such as the following, would be imposed in order to facilitate the search for acquirers as well as to ensure earlier resolution of problem cases while some value remains in the institution. If an institution is determined by FSLIC to be 24 months from insolvency, it would be instructed to seek out a merger partner. If an institution is 12 months from insolvency, FSLIC would have 90 days to find a merger partner. If no merger partner can be found, the institution would be declared insolvent, go into receivership and be acquired by this new corporation.

Such a time schedule would facilitate action by the regulators on a timely basis, and help to conserve FSLIC resources. It would also provide strong incentives for institutions to improve their operations or voluntarily seek merger partners. For example, an institution which is put originally on the "24-month list" would be removed from that list if its condition improved sufficiently. On the other hand, if the institution deteriorates suddenly, this time frame would have to be accelerated.

While there are a number of details to be filled in, I believe that the foregoing represents a balanced, well-reasoned and comprehensive approach to strengthening the FSLIC. It emphasizes private sector involvement and can be implemented immediately. When combined with the improved interest rate environment in which all thrift institutions are now operating, it seems clear to us that FSLIC and the industry have sufficient reserves and future income prospects to solve their own problems.

Most importantly from the standpoint of the industry, we respectfully submit that prompt action on these recommendations will permit thrift industry problems to be resolved without the need for other counterproductive steps such as:

— Continuing the FSLIC special assessment which is costing the industry $250 million per quarter;

— Recapitalizing FSLIC via a major infusion of funds from insured institutions on either a debt or equity basis;

- Continuing the current FHLBB prohibition on interstate mergers between healthy thrift institutions, which is placing the industry at a disadvantage vis-a-vis commercial banks;
- Authorizing the FHLBB to override state-granted banking powers which have been a source of considerable innovation and progress for the thrift industry;
- Expanding the supervisory and enforcement authority of the FSLIC over insured institutions;
- Enacting a "thrift test" that would only serve to limit the asset flexibility so necessary to the continued recovery of both savings banks and savings and loan associations; and
- Merging FSLIC into FDIC which would threaten the long-term viability of the separate regulatory system for savings and loans and federal savings banks.

OTHER ISSUES

I would now like to address those items mentioned in your letter inviting us to testify that have not already been covered in the course of my remarks.

Brokered Deposits - The National Council was strongly opposed to the brokered deposits restrictions promulgated last year by both the FDIC and the FSLIC. In our view, those regulations constituted an overreaction and we were glad that the ensuing litigation resulted in their withdrawal. We believe that, properly utilized, brokered deposits can be an effective liability management technique.

The appropriate regulatory response should focus on establishing reasonable limits on brokered deposits in a manner that is related to the net worth of individual institutions. Various legislative proposals dealing with this issue, such as H.R. 107 by Congressman Garcia, reflect a more balanced approach that provides sufficient flexibility and protects the legitimate interests of the insurance funds.

Modified Payoff - The modified payoff theory as proposed by the FDIC, and actually practiced in selected cases such as Penn Square, is fraught with difficulty. The theory of this approach, which involves having depositors receive less than full payment on their deposits in excess of $100,000 is that it will enhance market discipline. In practice, however, the theory suffers from the defect that no one believes it will be used in all cases.

The very largest FDIC-insured banks, such as Continental, have not been subject to the modified payoff procedure. Thus the market perception may be that as long as money is in the largest banks, even if uninsured, depositors will not lose their funds. Conversely, if as a result of adoption of this policy, the FDIC makes a very strong statement that the modified payoff policy will be used in all cases. and depositors become skittish about particular banks, it could cause major disintermediation at the very first sign of potential problems.

Subordinated Debt Capital - The question of subordinated debt capital is related to the modified payoff in that it is likewise an effort to increase market discipline on insured institutions. Most recently this topic has been discussed in connection with the FDIC proposal that capital requirements for insured banks be increased from 6 to 9 per cent, with subordinated debt eligible to qualify as part of the additional 3 per cent.

The National Council agrees that subordinated debt can play an important role in rebuilding the net worth that is so necessary for savings institutions in today's deregulated financial environment. We are glad to see that both the Bank Board and the FDIC have recognized that subordinated debt, properly structured, should count toward capital. However, we have major reservations about the feasibility of an across-the-board increase in capital requirements at this time. As mentioned earlier, we support higher capital requirements for institutions that represent higher risks to the insurance funds.

Foreign Deposits - The question of whether insurance premiums should be assessed on the foreign deposits of U.S. institutions is one which both the FDIC and the Federal Reserve have recently commented upon favorably. We note that the Treasury in its policy paper "Recommendation for Change in the Federal Deposit Insurance System" (January, 1985), pointed out that as a practical matter foreign deposits at money center banks are perceived to be fully insured even though deposit insurance premiums are assessed only on U.S. deposits. We agree with the regulators that some changes should be made in this area in order to ensure that institutions which benefit from de facto deposit insurance coverage contribute commensurately to the deposit insurance fund.

Market Value Accounting - This is a topic on which there is very little agreement among regulators, the affected industry, or accounting practitioners. At the present time, of course, assets are carried on the books of depository institutions on an historical cost basis rather than current market values. At various times regulators have considered requiring institutions to undergo a one-time "mark to market", but such proposals have always been abandoned because of the overwhelmingly negative impact on the capital positions of depositories whether they be commercial banks or thrifts.

Another complicating factor is that mergers among thrift institutions that were effected in past years frequently entailed a "mark to market", with resultant goodwill being recognized as net worth under then prevailing Generally Accepted Accounting Principles. More recent mergers have not received comparable treatment, thus raising an equity problem. The bottom line is that we are confronted by a situation where it is simply impractical to make such a radical departure from present practice by instituting market value accounting. We would point out, however, that the industry restructuring that is already well underway at most institutions will, over time, serve to diminish the gap between book value and market value.

CONCLUSION

Mr. Chairman and Members of the Subcommittee, it is obvious that the proper functioning of the federal deposit insurance system is essential to the continued well-being of depository institutions, the customers which they serve and the economy in general. Likewise, there can be little doubt that both the FDIC and FSLIC are facing unprecedented strains on their resources due in part to the fact that the administration of both funds has failed to stay fully abreast of financial deregulation of the last several years. However, the National Council of Savings Institutions categorically rejects those legislative and regulatory solutions that would close this gap by slowing down or reversing the deregulation that has occurred to date.

The specific suggestions we have put forth today in the FSLIC area are designed to help assure continued public confidence in the nation's thrift institutions, while preserving the opportunity for well-managed institutions to grow and prosper in the years ahead. As our Task Force on Alternatives to Reregulation completes additional work, we will be glad to furnish you with its results.

I would be pleased to answer any questions which the Subcommittee Members may have.

Chairman St Germain. Thank you.

Now we will hear from our last member of the panel, George C. King, who appears on behalf of the National Association of State Savings and Loan Supervisors.

I am glad Ms. Oakar isn't here because I remember the Association of State Savings and Loan Supervisors testifying before us in the past. We had a discussion of the private insuring fund, the State-approved insuring fund in Ohio, and, boy, that testimony was really, something.

But anyway, proceed.

Mr. King. I am familiar with that, Mr. Chairman. I was present for those hearings, also.

STATEMENT OF GEORGE C. KING, VICE PRESIDENT, BOARD OF DIRECTORS, THE NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS

Mr. King. My name is George King. I am vice president of the National Association of State Savings and Loan Supervisors, and I am the State regulator of the State-chartered S&L's in North Carolina.

I appreciate the opportunity to provide the views of NASS&LS on what we believe to be an extremely important and timely subject matter—the need for changes in the existing system of Federal deposit insurance and depository institution regulation and supervision.

NASS&LS supports the concept of tying insurance premiums and capital requirements to the riskiness of activities engaged in by a particular insured institution. Implementation of a system whereby the burden of paying insurance premiums is placed upon those insured institutions engaged in activities which entail greater risk to the insurance fund is preferable to the flat rate insurance premium presently in effect.

Increasing an insured institution's capital requirements commensurate with its increased level of risk would work to protect the safety and soundness of not only that particular insured institution but also the deposit insurance system as a whole. While admittedly difficult, we should not dismiss the risk-related concepts as impossible to implement.

NASS&LS strongly opposes the concept of merging the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation. NASS&LS believes that such action would be of limited value and would act to further blur the lines of demarcation between the commercial banks and thrift institutions.

The perception of increased stability resulting from a merger of these insurance funds would be short-lived. The merger of the FDIC and FSLIC would act to concentrate regulatory power into one monumental agency and contribute to a loss of innovation and flexibility in the marketplace.

Recapitalization of the insurance fund, primarily FSLIC, should be a primary goal of everyone here today. NASS&LS supports one current proposal in regard to FSLIC to form what has become known as the 406 corporation. This corporation would be designed to purchase and hold the enormous amount of assets acquired by

FSLIC under supervisory circumstances and assume the responsibility of managing and liquidating these assets.

NASS&LS believes that it is imperative to improve the management and performance of these assets so as to maximize FSLIC's return on its investment in these assets.

The concept of a 406 corporation or similar proposal would free up the limited resources of FSLIC to adequately address current problems rather than manage the assets of past problems. In one way or another, the strength of the Federal Home Loan Bank System must be transferred to FSLIC.

The Federal Home Loan Bank System has vast resources which could and should be utilized to help alleviate today's problems and bolster the resources of FSLIC. The recapitalization of FSLIC is an issue which should be addressed immediately and provided the in-depth level of consideration warranted by its importance.

The proposal to increase the present level of deposit insurance coverage so as to insure 100 percent of all deposits, while laudable and arguably fostering public confidence in the financial services industry is, in reality, not feasible.

Increasing the insurance limit to the sky would eliminate all vestiges of market discipline from an insured institution's behavior. One-hundred percent deposit insurance would also contravene recent legislative and regulatory actions designed to increase supervision, induce market discipline, and increase the level of accountability of management officials of insured institutions.

Reduction of deposit insurance levels does not appear to be judicious at this time. Rather than reducing the present level of deposit insurance, NASS&LS believes a more appropriate course of action is to intensify the supervisory role of both Federal and State regulators.

We would like to once again go on record as acknowledging that the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corporation are the deposit insurance funds which have in the past, do presently, and will continue to instill the public confidence in our financial institution system. As we are all too well aware, public confidence is a keystone to any system of financial intermediation, not only in this country but in the free world as well.

To maintain this public confidence it is incumbent upon not only the Federal Government but also the respective State governments to see that all financial intermediaries conduct their operations in a safe and sound manner.

It is not and should not be the sole purview of the Federal Government to oversee the operations of the various forms of financial institutions in this country today. Rather, we believe that it is the responsibility of Congress to craft minimum operational standards for all financial institutions in this country, both federally chartered and State chartered. It is then the responsibility of the various State legislatures to determine appropriate operational standards for State-chartered institutions within this overall framework.

Improving our ability as regulators to assess the financial and operational condition of a financial institution is critical. Regulators, be they Federal or State, must be supplied with the most timely data available if they are to adequately fulfill their responsibilities. The deregulated environment in which we find ourselves today has prompted financial institutions to implement programs and policies which heretofore were unheard of. The issues of timely data and improved analytical techniques are ones which both Federal and State regulators are attempting to resolve.

Clearly, for any regulator, State or Federal, to effectively carry out his or her responsibilities the law must provide that regulator with the authority and powers necessary to do so. Absent this grant of powers, the regulator is ill equipped in today's deregulated marketplace to address the problems before they become unmanageable.

Improved disclosure with more timely data and intensified supervision by both Federal and State regulators will permit Congress to continue the deregulation process which it initiated several years ago and thereby best serve the interest and needs of the consumer while assuring the safety and soundness of our financial institutions.

Mr. Chairman, we have addressed several other issues that were included in your letter. They are included in our written testimony.

We certainly appreciate the opportunity to appear here before you today, and I will be glad to respond to any questions that this subcommittee might have.

[The prepared statement of Mr. King on behalf of the National Association of State Savings and Loan Supervisors follows:]

STATEMENT OF

GEORGE C. KING

VICE PRESIDENT, BOARD OF DIRECTORS

THE NATIONAL ASSOCIATION OF STATE SAVINGS & LOAN SUPERVISORS*

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

OCTOBER 3, 1985

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*The members of the National Association of State Savings & Loan Supervisors are the state officials who regulate state-chartered savings and loan institutions in the several states and territories. The members of NASS&LS supervise and examine some 2,300 state-chartered institutions with assets of approximately $250 billion. The members of the Board of Directors of NASS&LS are: L.L. Bowman III, Commissioner of the Texas Savings and Loan Department, State of Texas; George C. King, Administrator of the Savings and Loan Division, State of North Carolina; David L. Paul, Commissioner of the Division of Savings and Loan, State of Colorado; Charles H. Brown, Jr., Director of the Division of Savings and Loans, State of Maryland; William B. Lewis, Deputy Commissioner of the Division of Savings and Loan Associations, State of New Jersey; R. H. Lewis, Supervisor of the Division of Savings and Loan Associations, State of Washington; R. J. McMahon, Commissioner of the Office of Savings and Loans, State of Wisconsin; Gerald Oliver, Deputy Comptroller, Bureau of Thrift, Savings and Loan Section, State of Florida; and L. Scott Walshaw, Administrator of the Financial Institution Division, State of Nevada.

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THIS SUBCOMMITTEE, MY NAME IS GEORGE C. KING AND I AM VICE PRESIDENT OF THE BOARD OF DIRECTORS OF THE NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS. ADDITIONALLY, I AM THE ADMINISTRATOR OF THE SAVINGS AND LOAN DIVISION OF THE STATE OF NORTH CAROLINA. I APPRECIATE THIS OPPORTUNITY TO PROVIDE THE VIEWS OF NASS&LS ON WHAT WE BELIEVE TO BE AN EXTREMELY IMPORTANT AND TIMELY SUBJECT MATTER--THE NEED FOR CHANGES IN THE EXISTING SYSTEM OF FEDERAL DEPOSIT INSURANCE AND DEPOSITORY INSTITUTION REGULATION AND SUPERVISION. MY TESTIMONY WILL BY NECESSITY BE BRIEF. HOWEVER, PLEASE DO NOT BE MISLED BY THE BREVITY OF MY TESTIMONY, THE ISSUES BEFORE THIS SUBCOMMITTEE TODAY ARE EXTREMELY COMPLEX AND COULD BE THE SUBJECT OF EXTENSIVE ANALYSIS AND DISCUSSION. IT IS NASS&LS' HOPE THAT THESE HEARINGS WILL INDEED FOSTER SUCH ANALYSIS AND DISCUSSION IN THE COMING MONTHS AS CONGRESS ATTEMPTS TO ADDRESS THE CONCERNS SHARED BY US ALL REGARDING THE MAINTENANCE OF A SOUND FINANCIAL SERVICES INDUSTRY.

THE VARIOUS DEPOSIT INSURANCE REFORMS OUTLINED IN THE CHAIRMAN'S LETTER OF SEPTEMBER 20TH INVITING ME TO TESTIFY THIS MORNING COVER A WIDE SPECTRUM OF POSSIBILITIES AND ALTERNATIVES AND ARE INDICATIVE OF THE EXTREMELY DIFFICULT TASK WHICH CONFRONTS EACH OF US CONCERNED WITH THE PERPETUATION OF A FINANCIAL SERVICES INDUSTRY SECOND TO NONE. NASS&LS, LIKE ITS FEDERAL COUNTERPARTS, HAS CONSIDERED MANY OF THESE PROPOSED DEPOSIT INSURANCE REFORMS AND BELIEVES THAT ACCEPTABLE SOLUTIONS TO THE PROBLEMS AT HAND ARE POSSIBLE. THROUGH A CONCERTED EFFORT OF BOTH FEDERAL AND STATE LEGISLATURES AND REGULATORY BODIES, APPROPRIATE MODIFICATIONS TO OUR EXISTING SYSTEM OF FEDERAL DEPOSIT INSURANCE AND DEPOSITORY INSTITUTION REGULATION AND SUPERVISION CAN AND MUST BE ACHIEVED.

RISK-RELATED DEPOSIT INSURANCE PREMIUMS AND RISK-RELATED CAPITAL REQUIREMENTS

NASS&LS SUPPORTS THE CONCEPT OF TYING INSURANCE PREMIUMS AND CAPITAL REQUIREMENTS TO THE RISKINESS OF THE ACTIVITIES ENGAGED IN BY A PARTICULAR INSURED INSTITUTION. IMPLEMENTATION OF A SYSTEM WHEREBY THE BURDEN OF PAYING INSURANCE PREMIUMS IS PLACED UPON THOSE INSURED INSTITUTIONS ENGAGED IN ACTIVITIES WHICH ENTAIL GREATER RISK TO THE INSURANCE FUND IS PREFERABLE TO THE FLAT-RATE INSURANCE PREMIUM PRESENTLY IN EFFECT. INCREASING AN INSURED INSTITUTION'S CAPITAL REQUIREMENT COMMENSURATE WITH ITS INCREASED LEVEL OF RISK WOULD WORK TO PROTECT THE SAFETY AND SOUNDNESS OF NOT ONLY THAT PARTICULAR INSURED INSTITUTION BUT ALSO THE DEPOSIT INSURANCE SYSTEM AS A WHOLE.

IT IS POSSIBLE THAT BY INCREASING AN INSURED INSTITUTION'S INSURANCE PREMIUM IN RESPONSE TO AN INCREASED LEVEL OF RISK, THE INSURED INSTITUTION WOULD THEN FIND IT MORE DIFFICULT TO ACHIEVE AND MAINTAIN A HIGHER CAPITAL LEVEL. NASS&LS BELIEVES THAT A SLIDING SCALE MIGHT BE DEVELOPED WHICH CONSIDERS VARYING LEVELS OF RISK. ONCE THE LEVEL OF RISK HAS BEEN ASCERTAINED A FORMULA, FACTORING IN BOTH INSURANCE PREMIUMS AND CAPTIAL REQUIREMENTS, WOULD NEED TO BE ESTABLISHED THEREBY CREATING A MIX OF THE TWO RISK-RELATED CONCEPTS. THIS FORMULA WOULD NEED TO BE DESIGNED SO AS NOT TO TRIGGER AN UPWARD SPIRAL OF RISKY ACTIVITIES WHICH EFFECTIVELY WOULD BE A PUSH-PULL SCENARIO. THE FOREGOING ACKNOWLEDGES THE DIFFICULTY OF DEFINING THE TERMS "RISK" AND "RISKY" AND THE POLITICAL REALITIES SURROUNDING THE DETERMINATION OF WHO SHALL ESTABLISH SUCH DEFINITIONS AND ACCOMPANYING STANDARDS OF CONDUCT. WHILE ADMITTEDLY DIFFICULT, WE SHOULD NOT DISMISS THESE RISK-RELATED CONCEPTS AS IMPOSSIBLE TO IMPLEMENT. A PANEL

COMPRISED OF FEDERAL AND STATE REGULATORS AND INDUSTRY REPRESENTATIVES MIGHT BE ONE METHOD OF RENDERING A DETERMINATION ON HOW BEST TO APPROACH AND IMPLEMENT THESE CONCEPTS.

MERGER OF THE INSURANCE FUNDS

NASS&LS STRONGLY OPPOSES THE CONCEPT OF MERGING THE FEDERAL DEPOSIT INSURANCE CORPORATION AND THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION. NASS&LS BELIEVES THAT SUCH ACTION WOULD BE OF LIMITED VALUE AND WOULD ACT TO FURTHER BLUR THE LINES OF DEMARCATION BETWEEN COMMERCIAL BANKS AND THRIFT INSTITUTIONS. THE PERCEPTION OF INCREASED STABILITY RESULTING FROM A MERGER OF THE INSURANCE FUNDS WOULD BE SHORT LIVED. THE QUALITY OF ASSETS PROBLEM IS BY NO MEANS LIMITED TO THE SAVINGS AND LOAN INDUSTRY. THE SAVINGS AND LOAN INDUSTRY IS NO MORE A VICTIM OF ITS BAD LOANS THAN ANY OTHER AREA OF OUR FINANCIAL SERVICES INDUSTRY. COMMERCIAL BANKS HAVE THEIR ENERGY AND AGRICULTURE LOANS AND THE MONEYCENTER BANKS HAVE THEIR PORTFOLIOS LADEN WITH FOREIGN LOANS WHICH ARE QUESTIONABLE AT BEST. THE MERGER OF THE FDIC AND THE FSLIC WOULD ACT TO CONCENTRATE REGULATORY POWER INTO ONE MONUMENTAL AGENCY AND CONTRIBUTE TO A LOSS OF INNOVATION AND FLEXIBILITY IN THE MARKET PLACE.

INSURANCE FUND RECAPITALIZATION

RECAPITALIZATION OF THE INSURANCE FUNDS, PRIMARILY THE FSLIC, SHOULD BE A PRIMARY GOAL OF EVERYONE HERE TODAY. NASS&LS SUPPORTS ONE CURRENT PROPOSAL, IN REGARD TO THE FSLIC, TO FORM WHAT HAS BECOME KNOWN AS THE "406 CORPORATION." THIS CORPORATION WOULD BE DESIGNED TO PURCHASE AND HOLD THE ENORMOUS AMOUNT OF

ASSETS ACQUIRED BY THE FSLIC UNDER SUPERVISORY CIRCUMSTANCES AND ASSUME THE RESPONSIBILITY OF MANAGING AND LIQUIDATING THESE ASSETS. NASS&LS BELIEVES THAT IT IS IMPERATIVE TO IMPROVE THE MANAGEMENT AND PERFORMANCE OF THESE ASSETS SO AS TO MAXIMIZE THE FSLIC'S RETURN ON ITS "INVESTMENT" IN THESE ASSETS.

NASS&LS BELIEVES THAT YET ANOTHER RESPONSE TO THE PRESENT STATE OF AFFAIRS MIGHT BE TO DECENTRALIZE THE FSLIC. A DECENTRALIZATION OF THE FSLIC WOULD IMPROVE ITS ABILITY TO COPE WITH THE SERIOUS PROBLEMS WHICH IT NOW FACES. THE RESPONSIBILITIES OF THE FSLIC COULD BE DISBURSED TO THE DISTRICT BANKS OF THE FEDERAL HOME LOAN BANK SYSTEM. ALTERNATIVELY, A DECENTRALIZED FSLIC COULD BE STRUCTURED AS AN INDEPENDENT NETWORK. IN ANY EVENT, NASS&LS STRONGLY BELIEVES THAT THE RESPECTIVE STATE SUPERVISORS SHOULD HAVE A LARGER VOICE IN THE RESOLUTION OF SUPERVISORY PROBLEMS WHICH REQUIRE THE USAGE OF FSLIC FUNDS. STATE SUPERVISORS SHOULD BE INVOLVED IN THE DECISION-MAKING PROCESS IN CONJUNCTION WITH THE FEDERAL AUTHORITIES BECAUSE THEY ARE MORE COGNIZANT OF WHAT IS HAPPENING TO THEIR RESPECTIVE STATE-CHARTERED SAVINGS AND LOANS THAN THE FEDERAL AUTHORITIES. I CANNOT STRESS ENOUGH THE NEED FOR TEAM WORK AND OPEN LINES OF COMMUNICATION BETWEEN FEDERAL AND STATE REGULATORS TO MORE EFFECTIVELY DEAL WITH THE CHANGING FACE OF THE SAVINGS AND LOAN INDUSTRY.

THE CONCEPT OF A 406 CORPORATION OR SIMILAR PROPOSAL WOULD FREE UP THE LIMITED RESOURCES OF THE FSLIC TO ADEQUATELY ADDRESS CURRENT PROBLEMS RATHER THAN MANAGE THE ASSETS OF PAST PROBLEMS. IN ONE WAY OR ANOTHER, THE STRENGTH OF THE FEDERAL HOME LOAN BANK SYSTEM MUST BE TRANSFERRED TO THE FSLIC. THE FEDERAL HOME LOAN BANK SYSTEM HAS VAST RESOURCES WHICH COULD AND SHOULD BE UTILIZED TO

HELP ALLEVIATE TODAY'S PROBLEMS AND BOLSTER THE RESOURCES OF THE FSLIC. THE RECAPITALIZATION OF THE FSLIC IS AN ISSUE WHICH SHOULD BE ADDRESSED IMMEDIATELY AND PROVIDED THE IN DEPTH LEVEL OF CONSIDERATION WARRANTED BY ITS IMPORTANCE.

100% DEPOSIT INSURANCE COVERAGE/REDUCED DEPOSIT INSURANCE COVERAGE

THE PROPOSAL TO INCREASE THE PRESENT LEVEL OF DEPOSIT INSURANCE COVERAGE SO AS TO INSURE 100% OF ALL DEPOSITS, WHILE LAUDABLE AND ARGUABLY FOSTERING PUBLIC CONFIDENCE IN THE FINANCIAL SERVICES INDUSTRY IS, IN REALITY, NOT FEASIBLE. IT WOULD BE EXTREMELY DIFFICULT, IF NOT IMPOSSIBLE, TO INCREASE THE RESERVES OF THE FDIC AND THE FSLIC FAST ENOUGH OR GREAT ENOUGH TO MATCH THE CONCURRENT INCREASED LEVEL OF RISK. RATHER, PUBLIC CONFIDENCE WOULD BE DIMINISHED AS A RESULT OF THE CONSUMER'S AWARENESS OF THE INABILITY OF THE INSURANCE FUNDS TO COPE WITH A 100% PAYMENT IN THE EVENT OF A LIQUIDITY CRISIS. ADDITIONALLY, INCREASING THE INSURANCE LIMIT TO THE "SKY" WOULD ELIMINATE ALL VESTIGES OF MARKET DISCIPLINE FROM AN INSURED INSTITUTION'S BEHAVIOR. 100% DEPOSIT INSURANCE WOULD ALSO CONTRAVENE RECENT LEGISLATIVE AND REGULATORY ACTIONS DESIGNED TO INCREASE SUPERVISION, INDUCE MARKET DISCIPLINE AND INCREASE THE LEVEL OF ACCOUNTABILITY OF MANAGEMENT OFFICIALS OF INSURED INSTITUTIONS.

A REDUCTION OF DEPOSIT INSURANCE LEVELS DOES NOT APPEAR TO BE JUDICIOUS AT THIS TIME. AN EXTENDED STUDY OF WHAT CONSTITUTES THE APPROPRIATE LEVEL OF DEPOSIT INSURANCE COULD BE INITIATED IN AN EFFORT TO DETERMINE THE MINIMUM LEVEL WHICH WILL ACHIEVE THE GOAL OF FOSTERING CONFIDENCE IN OUR FINANCIAL SERVICES INDUSTRY. RATHER THAN REDUCING THE PRESENT LEVEL OF DEPOSIT INSURANCE, NASS&LS BELIEVES A MORE APPROPRIATE COURSE OF ACTION IS TO INTENSIFY THE SUPERVISORY ROLE OF BOTH FEDERAL AND STATE REGULATORS.

INCREASED DISCLOSURE AND INTENSIFIED SUPERVISION

NASS&LS WOULD LIKE TO ONCE AGAIN GO ON RECORD AS ACKNOWLEDGING THAT THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION AND THE FEDERAL DEPOSIT INSURANCE CORPORATION ARE THE DEPOSIT INSURANCE FUNDS WHICH HAVE IN THE PAST, DO PRESENTLY, AND WILL CONTINUE TO INSTILL PUBLIC CONFIDENCE IN OUR FINANCIAL INSTITUTION SYSTEM. AS WE ARE ALL TOO WELL AWARE, PUBLIC CONFIDENCE IS THE KEYSTONE TO ANY SYSTEM OF FINANCIAL INTERMEDIATION, NOT ONLY IN THIS COUNTRY BUT IN THE FREE WORLD AS WELL. TO MAINTAIN THIS PUBLIC CONFIDENCE IT IS INCUMBENT UPON NOT ONLY THE FEDERAL GOVERNMENT BUT ALSO THE RESPECTIVE STATE GOVERNMENTS TO SEE THAT ALL FINANCIAL INTERMEDIARIES CONDUCT THEIR OPERATIONS IN A SAFE AND SOUND MANNER. IT IS NOT AND SHOULD NOT BE THE SOLE PURVIEW OF THE FEDERAL GOVERNMENT TO OVERSEE THE OPERATIONS OF THE VARIOUS FORMS OF FINANCIAL INSTITUTIONS IN THIS COUNTRY TODAY. RATHER, NASS&LS BELIEVES THAT IT IS THE RESPONSIBILITY OF CONGRESS TO CRAFT MINIMUM OPERATIONAL STANDARDS FOR ALL FINANCIAL INSTITUTIONS IN THIS COUNTRY, BOTH FEDERALLY-CHARTERED AND STATE CHARTERED. IT IS THEN THE RESPONSIBILITY OF THE VARIOUS STATE LEGISLATURES TO DETERMINE APPROPRIATE OPERATIONAL STANDARDS FOR STATE-CHARTERED INSTITUTIONS WITHIN THIS OVERALL FRAMEWORK. THIS CONCEPT IS NOT WITHOUT PRECEDENT. THE DISBURSEMENT OF FEDERAL HIGHWAY FUNDS TO THE VARIOUS STATES IS ONE SUCH EXAMPLE. IF THE STATE IS NOT IN COMPLIANCE WITH MINIMUM STANDARDS AS ESTABLISHED BY THE FEDERAL GOVERNMENT, THEN FUNDS MAY BE WITHHELD.

IMPROVING OUR ABILITY AS REGULATORS TO ASSESS THE FINANCIAL AND OPERATIONAL CONDITION OF A FINANCIAL INSTITUTION IS CRITICAL. REGULATORS, BE THEY FEDERAL

OR STATE, MUST BE SUPPLIED WITH THE MOST TIMELY DATA AVAILABLE IF THEY ARE TO ADEQUATELY FULFILL THEIR RESPONSIBILITIES. THE DEREGULATED ENVIRONMENT IN WHICH WE FIND OURSELVES TODAY HAS PROMPTED FINANCIAL INSTITUTIONS TO IMPLEMENT PROGRAMS AND POLICIES WHICH HERETOFORE WERE UNHEARD OF. THE ISSUES OF TIMELY DATA AND IMPROVED ANALYTICAL TECHNIQUES ARE ONES WHICH BOTH FEDERAL AND STATE REGULATORS ARE ATTEMPTING TO RESOLVE. IN AN EFFORT TO "KEEP UP" WITH THE INDUSTRY, CERTAIN STATES HAVE BEGUN TO RESPOND TO WHAT IS PERCEIVED TO BE AN INFORMATIONAL GAP. THE OFFICE OF SAVINGS AND LOANS OF THE STATE OF WISCONSIN HAS IMPLEMENTED A FULLY AUTOMATED SYSTEM TO CONDUCT ONGOING AND PRELIMINARY REVIEWS OF WISCONSIN-CHARTERED SAVINGS AND LOANS. THE TEXAS SAVINGS AND LOAN DEPARTMENT RECENTLY INITIATED A COMPREHENSIVE MONITORING SYSTEM FOR STATE-CHARTERED SAVINGS AND LOANS WHICH WILL GREATLY ENHANCE THE TEXAS COMMISSIONER'S ABILITY TO ASSESS THE CONDITION OF TEXAS-CHARTERED SAVINGS AND LOANS. IN ADDITION, THE TEXAS LEGISLATURE HAS RECENTLY REVISED AND RECODIFIED THE TEXAS SAVINGS AND LOAN CODE IN AN EFFORT TO PROVIDE THE SAVINGS AND LOAN DEPARTMENT WITH EXPANDED AUTHORITY IN DEALING WITH INSTITUTIONS UNDER ITS JURISDICTION. THESE EXPANDED POWERS INCLUDE THE ABILITY TO ISSUE CEASE AND DESIST ORDERS, INSTITUTE CONSERVATORSHIPS AND MORE CLOSELY REGULATE ANY CHANGE IN CONTROL (INCLUDING HOLDING COMPANIES) OF SAVINGS AND LOANS CHARTERED IN THE STATE OF TEXAS. CLEARLY, FOR ANY REGULATOR, STATE OR FEDERAL, TO EFFECTIVELY CARRY OUT HIS OR HER RESPONSIBILITIES THE LAW MUST PROVIDE THAT REGULATOR WITH THE AUTHORITY AND POWERS NECESSARY TO DO SO. ABSENT THIS GRANT OF POWERS, THE REGULATOR IS ILL EQUIPPED IN TODAY'S DEREGULATED MARKETPLACE TO ADDRESS THE PROBLEMS BEFORE THEY BECOME UNMANAGEABLE.

NASS&LS BELIEVES THAT THE ISSUE IS NOT AND SHOULD NEVER BECOME ONE OF WHETHER FEDERAL EXAMINATION AND SUPERVISORY PERSONNEL ARE "BETTER" THAN THEIR STATE COUNTERPARTS. TO ENGAGE IN A FRUITLESS DEBATE OF THIS NATURE WOULD ONLY ENGENDER ILL WILL AND CREATE AN UNWARRANTED "TURF" BATTLE, WHILE LOSING SIGHT OF THE REAL ISSUES. THE PRESERVATION OF PUBLIC CONFIDENCE IN A SAFE AND SOUND FINANCIAL INSTITUTION SYSTEM (ULTIMATELY FOR THE BENEFIT OF THE CONSUMER) SHOULD BE THE PRIMARY GOAL OF EACH OF US HERE TODAY. MY DUTY AS A REGULATOR IS NOT TO PROTECT THE INSURANCE FUND AT ALL COSTS. RATHER, MY DUTY IS TO PRESERVE THE SAFETY AND SOUNDNESS OF THE FINANCIAL INSTITUTION SYSTEM, FOR THE BENEFIT OF THE CONSUMER, OF WHICH THE INSURANCE FUNDS ARE AN INTEGRAL ELEMENT THEREOF. ONE WAY IN WHICH NASS&LS BELIEVES THAT THE SAFETY AND SOUNDNESS OF THE FINANCIAL INSTITUTION SYSTEM MAY BE ENHANCED IS FOR A UNIFORM STANDARD TO BE ESTABLISHED FOR EXAMINATION AND SUPERVISORY PERSONNEL. SUCH A STANDARD, WITH ITS QUALIFICATION AND MAINTENANCE REQUIREMENTS, WOULD APPLY EQUALLY TO FEDERAL AND STATE EXAMINERS AND SUPERVISORS. IN THIS WAY NO CLAIMS COULD BE LEVELED IN EITHER DIRECTION REGARDING QUALITY OF PERSONNEL. ADDITIONALLY, AS IT SHOULD BE IN ANY CASE, STATE AND FEDERAL EXAMINATION AND SUPERVISORY PERSONNEL SHOULD COMPLIMENT ONE ANOTHER BY WORKING IN TANDEM WITH A FREE EXCHANGE OF INFORMATION AND IDEAS. A COMBINED EFFORT WOULD SURELY BE MORE SUCCESSFUL IN PROTECTING THE AMERICAN CONSUMER'S INTEREST THAN A BIFURCATED APPROACH.

IMPROVED DISCLOSURE WITH MORE TIMELY DATA AND INTENSIFIED SUPERVISION BY BOTH FEDERAL AND STATE REGULATORS WILL PERMIT CONGRESS TO CONTINUE THE DEREGULATION PROCESS WHICH IT INITIATED SEVERAL YEARS AGO AND THEREBY BEST SERVE THE INTERESTS AND NEEDS OF THE CONSUMER WHILE ASSURING THE SAFTEY AND SOUNDNESS OF OUR FINANCIAL INSTITUTIONS.

SUPPLEMENTAL FUNDS

NASS&LS RESPECTFULLY OFFERS ONE RESPONSE TO THE PRESENT SITUATION RELATIVE TO THE STATUS OF THE FEDERAL DEPOSIT INSURANCE FUNDS. THE STATE OF TEXAS HAS RECENTLY ENACTED LEGISLATION WHICH PROVIDES FOR THE ESTABLISHMENT OF A FUND TO SUPPLEMENT THE FSLIC. THIS ACT, WHICH IS ENTITLED THE "TEXAS SAVINGS AND LOAN SUPPLEMENTAL FUND ACT," WAS CREATED FOR THE FOLLOWING PURPOSE:

> A FUND IN TEXAS TO AID AND ASSIST THE SAVINGS AND LOAN COMMISSIONER OF TEXAS IN MAINTAINING THE SOLVENCY OF THE ASSOCIATIONS THAT CONTRIBUTE TO THE FUND AND TO SAFEGUARD THE PUBLIC INTEREST AND PROMOTE THE PUBLIC CONFIDENCE IN STATE CHARTERED SAVINGS AND LOAN ASSOCIATIONS DOING BUSINESS IN THE STATE OF TEXAS BY MAKING AVAILABLE TO THE SAVINGS AND LOAN COMMISSIONER OF TEXAS THE ADDITIONAL RESOURCE OF THIS FUND TO BE USED FOR THE PROTECTION AND REHABILITATION OF MEMBER ASSOCIATIONS' ASSETS AS WELL AS THE MAINTENANCE OF THE SOLVENCY OF MEMBER ASSOCIATIONS.

THE PRACTICAL EFFECT OF THIS SUPPLEMENTAL FUND IS TO INDEMNIFY THE FSLIC WHILE THE FSLIC REMAINS THE INSURER OF DEPOSITS. THE SUPPLEMENTAL FUND WOULD INSURE THE ASSETS OF THOSE STATE-CHARTERED SAVINGS AND LOANS WHO ARE CONTRIBUTORS TO THE SUPPLEMENTAL FUND. IN EXCHANGE FOR THIS SUPPLEMENTAL CONTRIBUTION, THE MEMBER ASSOCIATION MAY EXERCISE THE AUTHORITY GRANTED TO IT BY THE STATE LEGISLATURE (KEEPING IN MIND THE MINIMUM NATIONAL STANDARDS DISCUSSED

ABOVE). STATE-CHARTERED SAVINGS AND LOANS WHICH ARE NOT MEMBERS OF THE SUPPLEMENTAL FUND WOULD NOT HAVE THE AUTHORITY TO EXERCISE LENDING AND INVESTMENT AUTHORITY BEYOND THAT GRANTED TO FEDERALLY-CHARTERED SAVINGS AND LOANS. THE TEXAS SUPPLEMENTAL FUND WILL INITIALLY BE CAPITALIZED BY EACH MEMBER ASSOCIATION TRANSFERRING TO THE SUPPLEMENTAL FUND CASH EQUAL TO 2% OF ITS TANGIBLE ASSETS IN RETURN FOR AN INVESTMENT CERTIFICATE. THE RETURN ON THIS INVESTMENT WILL BE 2% BELOW THE MARKET RATE OF RETURN. THE SPREAD WILL BE RETAINED BY THE SUPPLEMENTAL FUND WHICH WILL ENHANCE THE CORPUS OF THE SUPPLEMENTAL FUND ITSELF. AN ADDITIONAL METHOD TO CAPITALIZE THE SUPPLEMENTAL FUND COULD BE TO ASSESS A PREMIUM ON LOANS MADE PURSUANT TO THE EXPANDED STATE AUTHORITY SIMILAR TO THAT DEVELOPED FOR MORTGAGE LOANS. IF THE LOAN TO VALUE RATIO IS GREATER THAN 80% THEN THE BORROWER MUST PAY A MARGINALLY HIGHER RATE OF INTEREST THAN WOULD BE REQUIRED IF THE LOAN TO VALUE RATIO WERE 80% OR LESS. THIS ADDITIONAL INTEREST ASSESSMENT WOULD BE APPLIED TO THE SUPPLEMENTAL FUND FOR THE LIFE OF THE LOAN.

THE SUPPLEMENTAL FUND CONCEPT PROVIDES PROTECTION TO THE FSLIC IN THE FORM OF INDEMNIFICATION OF THE ADDITIONAL RISK ASSUMED BY A MEMBER ASSOCIATION. THE SUPPLEMENTAL FUND WILL PROMOTE SELF DISCIPLINE WITHIN THE SAVINGS AND LOAN INDUSTRY. MEMBER ASSOCIATIONS ARE REQUIRED TO ASSUME A LEVEL OF THE RISK INCURRED BY OTHER MEMBER ASSOCIATIONS. I VENTURE TO SAY A SELF MONITORING SYSTEM WOULD SOON FALL INTO PLACE. NASS&LS BELIEVES THAT THE CONCEPT OF STATE SPONSORED SUPPLEMENTAL FUNDS IS A VIABLE RESPONSE TO THE PRESENT CIRCUMSTANCES RELATING TO DEPOSIT INSURANCE AND IS WORTHY OF ANALYSIS AND DISCUSSION BY THIS DISTINGUISHED SUBCOMMITTEE.

CONCLUSION

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE SUBCOMMITTEE, THE NATIONAL ASSOCIATION OF STATE SAVINGS & LOAN SUPERVISORS COMES BEFORE YOU TODAY OFFERING ITS THOUGHTS ON THE VERY COMPLEX ISSUES AT HAND. WE PRESENT POSSIBLE COURSES OF ACTION, SOME BEING ATTEMPTED AND SOME MERELY CONCEPTS. WE DO NOT OFFER ANY CURE-ALL, BUT ONLY WHAT NASS&LS BELIEVES MIGHT BE SOME POSITIVE STEPS TO HELP THE EXISTING SYSTEM OF FEDERAL DEPOSIT INSURANCE AND, CONSEQUENTLY, THE SAVINGS AND LOAN INDUSTRY, REGAIN THE STRENGTH WHICH IT SO DESPERATELY NEEDS. THE SAVINGS AND LOAN INDUSTRY ON THE WHOLE NEEDS TO RETURN TO A BASIC DEFINITION OF WHAT CONSTITUTES NET WORTH AND WE BELIEVE IT SHOULD BE TANGIBLE NET WORTH. CONGRESS MUST ADDRESS ITSELF TO THE VERY SERIOUS PROBLEMS OF THE FEDERAL DEPOSIT INSURANCE SYSTEM AND ITS PLACE IN TODAY'S RELATIVELY DEREGULATED AND CONTINUALLY CHANGING FINANCIAL SERVICES MARKETPLACE. ONCE CONGRESS HAS SUCCEEDED IN DEVELOPING AN ACCEPTABLE PLAN TO RESTORE THE HEALTH OF OUR FEDERAL DEPOSIT INSURANCE SYSTEM THEN, AND ONLY THEN, CAN THE SAVINGS AND LOAN INDUSTRY BEGIN TO EMBARK ON A SUSTAINED RECOVERY. THE DEPOSIT INSURANCE SYSTEM MUST BE MODIFIED TO CO-EXIST WITH TODAY'S CHANGING MARKETPLACE FOR FINANCIAL SERVICES.

THANK YOU FOR THIS OPPORTUNITY TO EXPRESS NASS&LS' POSITION ON THESE EXTREMELY IMPORTANT ISSUES. WE LOOK FORWARD TO WORKING IN HARMONY WITH YOU AND YOUR STAFF AS YOU ENDEAVOR TO CRAFT AN APPROPRIATE LEGISLATIVE RESPONSE TO DEAL WITH THESE COMPLEX ISSUES. I LOOK FORWARD TO RESPONDING TO ANY QUESTIONS WHICH YOU MIGHT HAVE CONCERNING NASS&LS' OPINIONS.

Chairman St Germain. Thank you, Mr. King.

Mr. Backlund, I think you are the one who suggested that improved computerization would be helpful to the regulators; right?

Mr. Backlund. Computerization?

Chairman St Germain. Pardon?

Mr. Backlund. Computerization?

Chairman St Germain. Yes, modernized techniques utilizing computers.

Mr. Backlund. I think the thing I suggested was the reform of the management and the staggered terms, but computer—I agree with what he says; yes.

Chairman St Germain. But I thought I heard you say that in your verbal presentation. Intensified supervision—oh, was it you, Mr. Cairns.

Mr. Cairns. Yes.

Chairman St Germain. Perhaps what they might do is consult with the chap who ran the computers during the Miss America contest. They picked Miss America on Wednesday; right? [Laughter.]

Amazing. If they could do that——

Mr. Backlund. Maybe they could find——

Chairman St Germain. Maybe they can find that same fellow. He could set up the program for our regulators.

Mr. LaFalce.

Mr. LaFalce. I pass.

Chairman St Germain. Mr. Hubbard.

Mr. Hubbard. I pass.

Chairman St Germain. Mr. Wylie.

Mr. Wylie. Thank you, Mr. Chairman. I am sorry to have been a little late and running in and out here this morning.

But I do want to take this chance to welcome this very distinguished panel. You have given us some very meaningful testimony.

We have had testimony over the last 3 weeks from academia, and we will have some testimony from the regulators themselves, and I think it is appropriate that we get testimony from industry leaders, who are, I would hope, the persons with the real expertise in this field and know that we do have a problem to resolve.

But I do observe again that we have a panel here, Mr. Chairman, with really no consensus as to how we should go about resolving this problem. Everybody thinks that we have a problem with reference to insurance of deposits.

But I would like to ask Mr. King. You have a little bit different approach than anything I have heard so far.

How does your concept of the section 406 corporation differ from the U.S. League proposal?

Mr. King. Sir, the proposal we spoke to is basically support of their proposal. You know, there is not that much known about it other than what we have read in the newspapers and the few things that have been available to us here in Washington, but that is basically what we were supporting.

It is not necessarily—well, I think probably it is the U.S. League plan or one very close to it.

That concept, the main thing is drawing on the resources of the Federal Home Loan Bank System, in which there is vast strength and net worth, so that the FSLIC can get on with dealing with current and potential future problems rather than having these past problems hanging around their neck in such manner.

Mr. WYLIE. We have been told by the regulators that basically our most serious problems arise in Texas, California, and Florida and relate directly to State-chartered S&L's.

In your prepared statement you state that NASS&LS believes it is the responsibility of Congress to craft minimum operational standards for all financial institutions in this country, both federally chartered and State chartered.

Does that mean that you would support Federal legislation which would place restrictions on direct investments or other activities if that institution is federally insured, even though State chartered?

Mr. KING. I think that rather than say we would specifically support that position we would support any position that would ensure some input, first of all, from the State regulators into that process and also that would ensure the safety and soundness of the financial institutions and the system itself.

Where we have a problem with that concept is the situation where the Federal regulators, and the Federal Home Loan Bank Board in particular, in some cases has attempted and in some cases actually completely circumvented the State regulators and the State statutes and regulations in dealing with some of these problems and promulgating some of these regulations.

Mr. WYLIE. OK.

Mr. Cairns, do you agree with Mr. Backlund that there are some banks that are too small to fail?

Mr. CAIRNS. I don't believe——

Mr. WYLIE. We have had the concept of two banks too large to fail with Continental Illinois.

Mr. CAIRNS. I don't think there is any bank too small or too large to fail.

Mr. BACKLUND. The word is "too small to save."

Mr. WYLIE. Or too small to save?

Mr. CAIRNS. Then I guess we do agree.

Mr. WYLIE. OK. Are small banks discriminated against by FDIC?

Mr. CAIRNS. Well, I don't know how to really answer that question. The one that always shows up in this discussion is what happened in the Continental situation.

Mr. WYLIE. Right.

Mr. CAIRNS. And I think you have heard from so many people this morning and certainly from us that we have chosen the modified payout as the approach we think is a favorable approach.

Mr. WYLIE. You support the modified payout approach?

Mr. CAIRNS. Yes, we do.

Mr. WYLIE. Do you know Mr. Huertas from Citibank?

Mr. CAIRNS. No, I don't.

Mr. WYLIE. He advocated that approach yesterday.

Chairman ST GERMAIN. Along with subordinated debt.

Mr. WYLIE. Along with subordinated debt. Would you approve that, too?

Mr. CAIRNS. We do not agree that subordinated debt is capital, and we think that to believe that all banks have the same access and therefore the same ability or even reasonable ability to acquire subordinated debt is really not looking at the facts. We think that would be difficult for small banks to do, and we question the real value of that approach, and we are opposed to subordinated debt requirements.

Mr. WYLIE. When the question arose as to what we might do as far as FSLIC especially is concerned—and maybe this is not a good question for you, but maybe I will ask it to the whole panel—I thought risk-related insurance sounded pretty good.

How many of you on the panel—and I should know the answer to this, and I am sorry I was out, in and out—how many of you on the panel would support risk-related insurance? Would you raise your hand?

Mr. BACKLUND. Risk-related premium?

Mr. WYLIE. Yes.

[Show of hands.]

Mr. WYLIE. One.

OK. How would you go about establishing risk?

Mr. CAIRNS. Congressman, that question is not quite as simple for me to answer as the question was put. We think the concept has merit. We haven't found a way to do it yet——

Mr. WYLIE. Well, that is a part of my problem.

Mr. CAIRNS. That is realistic.

Mr. WYLIE. May I say that the commercial banks in my particular district support risk-related insurance. They think it is a good idea, and they think they are well-run and well-operated and that they shouldn't have to pay for the sins of some others, where we get into fraud, abuse, and all that sort of thing.

Mr. CAIRNS. We agree with that part of it, you know, in the concept part. But the premiums and how you would go about—what kind of a formula, how effective it would be is the part that we are really struggling with, and I guess you were out when we commented we are working on this still and we hope to be able to come back with some more——

Mr. WYLIE. Please do some work on it because——

Mr. CAIRNS. We have not given up.

Mr. WYLIE. I am struggling with it, too. I think it is a good idea, but I am sure struggling.

Mr. Backlund, my time has expired, but if you could respond to that. The rest of you are all against it, so I won't ask you to comment.

Mr. RUTLAND. Mr. Chairman, I want to clarify. The National Council of Savings Institutions is not against risk-based premiums. It is on record as being in favor of the concept.

Mr. WYLIE. Oh, OK, good.

Mr. RUTLAND. We have added to that to say that we do believe there is something better, and that is a risk-based net worth requirement that would put net worth ahead of a call on the insurance fund.

Mr. WYLIE. OK.

Mr. RUTLAND. And that is even better.

Mr. WYLIE. Well, and, Mr. King, you are for it?

I wonder if it would be appropriate, Mr. Chairman, to ask them to put their mind to this and see if they could come up, maybe through their trade associations, with some language which might help us. If you can't, why, then we will understand. But if you can and think you can come up with——

Mr. Levy. We are not opposed to it in concept. The way Mr. Cairns stated it, it sounds like a very good idea, but first you have to describe what it is you are talking about in terms of a risk-based premium. If it is the actual payment of an additional premium, our concern is that the premium can't be high enough to change conduct.

So we share the National Council's position that we should focus more on net worth requirements and special additional capital requirements when institutions embark on certain kinds of activity because in that case they are actually putting up some of their own money, and if they are right they get to keep it. If they are wrong, the capital that has been put aside will absorb the results of any errors.

Mr. Wylie. Well, if you have any language on capital requirements, that would be helpful to this member, too.

And I don't think I will take any more time in committee because there are others that want to ask questions, and these would require some rather extensive answers, Mr. Chairman.

Chairman St Germain. Mr. Roth.

Mr. Roth. Yes. Mr. Backlund, much has been made here this morning and in our previous hearings about regulators have to do a better job. I see here on page 7 of your testimony where you address this in a very succinct manner.

You said, "We are tremendously disturbed by the FDIC's proposal to require increased disclosure."

Now, in my opinion, if the regulators are going to do a better job, you know, it seems that disclosure sort of dovetails with that, doesn't it?

Mr. Backlund. Well, theoretically, maybe it does. But, actually, under the present environment, the hyped up environment that has been created in this country about the financial institutions, disclosing enforcement actions could cause unjustified runs on banks. And this has come up. Little rumors in communities. We hear these horror stories about something's wrong in the bank and people start lining up. So that's the concern in this environment. We think it's very dangerous.

Mr. Roth. But if we're going to have increased market discipline and self-regulation, as some people have said here this morning, shouldn't we let the sunshine in? Isn't that one of the concepts that we have to endorse?

Mr. Backlund. Well, I think we should be very careful at this point in time about doing that.

And I wanted to say also about the risk-based premiums that we also have the same concerns about how it would be implemented. And, speaking personally, I think the risk-based capital concept may really be more practical and have more merit than the risk-based premium.

Mr. Roth. Mr. Cairns, you had mentioned to the obligation of the regulators and that they could be doing a better job, that we have to beef up the regulators, and so on.

How do you feel about that? You know, public confidence is very important in this area. How are we going to do that if we don't have more disclosure?

It seems to me, disclosure is a proper avenue for us to take.

Mr. **Cairns**. Well, I think that many have come to the conclusion that, if you disclose, the public becomes aware and everything gets solved. I don't think it's quite that simple. You almost have to—in this discussion, when we're talking about the insurance reform, if you agree that the modified payout concept is an important part of this thing, then your next question is: Who is at risk? And who is going to use this information? Who has the ability to use the information?

If you take the modified payout approach, and you say that those deposits under $100,000 are insured and those that are over are not. I would submit to you that there is a tremendous amount of data already being disclosed, and for people who have the means to have more than $100,000 in deposit, I think there's an awful lot for them to see now, and it could be better used.

But the fact that there's a general feeling of many people that all deposits are covered over $100,000, I don't think that the material that's out there is properly being used today.

Now, you talk about having a better job at the regulatory agencies and their examiners doing better jobs. Obviously, if they uncover fraud, for example, and we're told by Chairman Isaacs, for example, that a very large percentage of the banks that are closed because of fraud.

Obviously, if you find fraud quickly, more quickly, you will disclose it, and that will be very important to do, and get it behind us.

But, routine disclosures of enforcement action, picked up in small communities in the press, distributed to people who are not at risk and, therefore, not of a mind to necessarily understand that in great deal, could lead to the people——

Mr. **Roth**. I'm sorry. I know it's impolite to interrupt, but I must interrupt because I have only so much time, I don't want you to monopolize all the time. The point is that how are people supposed to know if they can't get the information? If you have more than $100,000 in the bank and you don't know what's happening to the bank or don't have enough information, it would seem that the banks would want all the information out. And the more information we can get to our regulators, the more public confidence we can have.

Mr. **Cairns**. I think the information that is necessary to determine the safety of a bank and whether a depositor should be maybe left over $100,000, that information, much of it is there today. And it's just there for the asking and for the taking and for the looking.

And it needs to be analyzed in that light.

Mr. **Roth**. Thank you.

Mr. Levy, in your written testimony, I think you also alluded to it in your verbal testimony today, you are opposed, of course, to the merger and you said one of the reasons FSLIC is sound today, because we have $5.3 billion, which is above the crisis level. Right?

Mr. **Levy**. That's correct.

Mr. ROTH. Well, what formula are we using? What is a crisis level? Suppose we had 4.3? Would we be at the crisis level then today? I mean, what standard do we use to get that?

Mr. LEVY. I think the standard we use is one of velocity. If we're at the front end of a rising crescendo of additional losses that we might be facing, we have one concern.

If we have crested, it's an entirely different story. And I think, if you look at all of the things that have taken place over the last 6 to 12 months, I suggest to you that we have crested. Consider the reregulation that was referred to, particularly limitations on growth. In 1983 and 1984, the industry grew at close to 20 percent. Since the growth limitations were put into effect on January 1, 1985, the industry has been growing at about 6 percent. Looking at this initiative along with the limitations on direct investment, there's been an expanded, regulatory structure that has stopped in effect the very rapid growth and the high fliers that have created the problems.

And I suggest to you that it should be recognized that a lot of the pieces that have been put in place—although others should be put in place—such as expanded temporary cease and desist authority—and that we are in a situation where we're beginning to manage the problem. In addition we are recapitalizing the FSLIC in a sense by paying an additional one-eighth on top of the other premiums so that the cash flow in is $2.3 billion annually.

We have put so many things into place just in the last 6 months, that I don't think we really are able at the present time to gauge and measure how effective they really are going to be in managing this problem.

Mr. ROTH. Mr. Levy, I know you're a very well-respected man and I know you're a brilliant man in this field, but I must differ somewhat, because if we just go by your contention, which is one of philosophy, there's nothing tangible. It's all nebulous. Then we get back to Mr. McEnteer's claim and his would be, as far a definition of "risk," we wouldn't have any; it would be up to each individual institution; because it all depends there are no two the same so you couldn't have any standard.

If we can't have any standard, we're not going to have any rules of the road.

Mr. LEVY. Congressman Roth, I think the point is, with the change in the interest rate cycle, the problem that we had with long-term low yield loans seems to have diminished. More and more institutions are profitable, over 80 percent. We're going to have the most profitable year in the history of the savings and loans business. Over $5 billion is going to be added to the capital base of the business. That's a major change.

The real problem has come from the asset problems. And in almost every one of those cases, you'll see the same scenario, very rapid high-flier-type growth; rapidly expanding institutions with the need to make major investments quickly, growth because they were paying rates that were above market levels, with a concomitant need then to invest that money at much higher rates to accept greater risk.

What I'm suggesting is that the limitation on growth in itself is a major step forward in putting a cap on the bottle.

Now, we've got the problems inside the bottle, but we don't want to let in more. And I'm saying that it's more manageable because while they're working with existing problems, we don't have the explosive atmosphere that we had in 1983 and 1984 in terms of growth.

There is a question here as to whether deregulation has caused the problems. I don't think it's deregulation that caused it. I think it was deregulation without a linkage to capital. We went through a 2- or 3-year period where institutions were permitted to grow with very little in terms of capital requirements. And we saw very rapid growth rates.

That has stopped and I think that's a major part of containing and managing this problem.

Mr. **Roth**. Thank you.

Thank you, Mr. Chairman.

Chairman **St Germain**. Mr. Bartlett.

Mr. **Bartlett**. Thank you, Mr. Chairman. I'd like to ask each of the witnesses that care to answer whether they generally concur with the proposal that was made at one point by the FDIC to increase the net worth requirements to 9 percent, assuming it would be phased in and fully giving the institutions a chance to comply?

Perhaps tied to risk-based premiums, as has been suggested here today. And, further, whether that same net worth requirement should apply equally to banks and to savings and loans.

Mr. Cairns.

Mr. **Cairns**. Well, to begin with, we have for a long time been of record suggesting that as long as we're going to be offering similar kinds of businesses in the marketplace, we ought to have similar rules, including capital requirements and the need to build that capital and support that capital.

So, from that perspective, across the line, thrifts and banks, we think they should have the same capital standard.

The second question you asked is whether you should run from 6 percent to 9 percent, which is a proposal I guess for increase in capital. And then you also mentioned the risk-related capital.

I think it's a little inconsistent. One is a variable capital based on what the risk is in the bank or the association. And the other is an arbitrary level. We don't think moving from 6 to 9, that there's been a case made to do that particularly. We don't think that fixed rate of 9 percent has been shown by anybody to assure safety and soundness.

We don't find the relationship between increase of that level of capital, and also there's a cost involved. But, the final point is there's a cost involved. To move that much would be $50 billion. It costs money to maintain capital and to raise capital, and somebody has to pay for that.

Mr. **Bartlett**. Mr. Cairns, we have a vote in about 9½ minutes now. I would ask the chairman if we could simply hold the record open and have each of the panelists respond in writing.

Chairman **St Germain**. If you want to ask a few more questions, we'll go to about 7 minutes.

Mr. **Bartlett**. If each of you could just sort of answer.

Mr. **Backlund**. OK, I will just make one comment, and that is that the 9 percent across-the-board capital requirement is ridiculous because there's such a different level of risk in individual institutions. One institution could theoretically have all Treasury bills, 60-day Treasury bills, in other words.

Mr. **Bartlett**. So, no, it ought to be variable, and should it apply to banks and savings and loans equally?

Mr. **Backlund**. It has to be based on the asset makeup of the bank.

Mr. **Bartlett**. Should it apply to banks and savings and loans equally?

Mr. **Backlund**. We of course think they should. We've always believed that.

Mr. **Bartlett**. Mr. Edgerly.

Mr. **Edgerly**. I would say that the Associations of Reserve City Bankers has yet to make definitive conclusions. The general point considered by our task force has been strongly focused on capital adequacy and on the potential utility of risk-based capital as a primary approach to this issue of risk.

Mr. **Bartlett**. Mr. McEnteer.

Mr. **McEnteer**. I'm a bank regulator in Pennsylvania and for some time, we have had a 6-percent capital ratio requirement and we've gotten most all of our banks up to that 6 percent ratio now. We can't see any reason to have 9 percent, any beneficial reason for that. Our banks are in good shape and operating profitably.

Mr. **Bartlett**. So you think 6 percent is adequate?

Mr. **McEnteer**. Six percent, we think is adequate.

Mr. **Bartlett**. Mr. Levy.

Mr. **Levy**. We would support a move to adopt like capital standards, moving toward a 6-percent standard. There are two points that we would make. First, we need a little longer time. It might be a 7-year period to get there because of the problems that we've had over the past 3 or 4 years.

And, No. 2, we think it should be monitored by our basic regulator, the Federal Home Loan Bank Board.

And let me say further on the question of the subordinated debt, we already have provisions under Federal Home Loan Bank Board regulations that once the debt falls below 7 years, you have to start reducing it off your statement. It is amortized.

Mr. **Bartlett**. OK. Mr. Rutland.

Mr. **Rutland**. In general, we would support exactly what the U.S. League has just stated, with one proviso, that the accounting rules should be the same. For instance, loss reserves are counted as part of capital for banks but are not counted for S&L's.

Mr. **Bartlett**. Make the accounting rules the same.

Mr. King.

Mr. **King**. We don't know what's magic about 9 percent. We would certainly support a phasein toward 6 percent. As Mr. McEnteer said about Pennsylvania, in North Carolina, we have had a 5-percent regulation even on the S&L's.

Mr. **Bartlett**. Thank you.

Mr. **McEnteer**. I might say, in Pennsylvania, our department also regulates the S&L's and we're pushing for the 6-percent capital ratio for that.

Chairman **St Germain**. The subcommittee will be in recess so that we may cast a vote. We will return within 5 to 10 minutes.

[Recess.]

Chairman **St Germain**. Mr. Levy and Mr. Rutland, in the dialog yesterday with one of the members of academia the witness was telling the subcommittee that a mortgage with low interest, low yielding mortgage, should be treated as having a value of less than 100 cents on the dollar; in other words, it should be carried on the books at a price that that mortgage would bring if it were to be sold off to someone else.

Now, we are all familiar with the proponents of market value accounting.

However—and I address this of you two gentlemen as well as Mr. King—if a mortgage is current, if the interest and principal are being paid on a regular basis, never any question about it, and the equity is there in a home far beyond the remaining balance on the mortgage, do you think that that gentleman is correct when he says that nevertheless that mortgage should not be carried on the books at 100 cents on the dollar but should be carried at fair market value; in other words, the price it would bring if it was sold out on the market, because of the low interest that it generates? Mr. Levy.

Mr. **Levy**. Well, we have heard these proposals, and of course we are directly into the issue of mark to market accounting. We underscore loans, those low yield loans are very sound credits. They are loans that were put on the books during the 1960's or 1970's. They have substantial equity. These people have been making payments for years. We know that we are going to get a repayment.

I think when you raise that issue you are really deep into the whole mark-to-market question. If you are going to apply it to us, do you apply it to banks? Do you take foreign loans and start looking at the level of interest and the repayment and the soundness of the credit, and do you mark that to market?

Do you look at every loan that you would be making, energy loans, farm loans, and account for it on the basis of what would it bring if you sold it tomorrow?

It would bring chaos, and I think that we are well served at the moment by carrying the loan at its full value.

In fact, in many cases loans that would have been sharply marked down during the extraordinary period of 1981 to 1983 are now at positive spreads. Loans that were 9 percent in a 16-percent market would have had an extraordinary markdown. Today those loans in many cases they are beginning to achieve a positive spread, and they are getting closer to market.

I would be strongly opposed to that.

Chairman **St Germain**. Mr. Rutland.

Mr. **Rutland**. I would also be opposed to it. I think that is an appropriate strategy for a trading account, but mortgages are not a trading account.

Chairman **St Germain**. Mr. King.

Mr. **King**. We basically agree with that, Mr. Chairman. Again, there are situations in which the savings and loan industry and the Bank Board in particular, with its conversion regulations, takes that into account when an appraisal is done on a mutual association that is converting the stock. That type of thing is taken into account because you are moving into, you know, a GAAP-type accounting situation and it must be accounted for.

But again it is not a trading account, such as investments, that the banks do mark to market on a regular basis. But again, as Mr. Levy said, it would absolutely bring chaos to the marketplace.

Chairman St Germain. Mr. McEnteer.

Mr. McEnteer. I agree with the testimony of these gentlemen. I am not convinced that mark to market is a viable tool in today's economy for the same reason that Mr. Levy expressed. The interest rates were high a few years ago. If those mortgages or other loans would have been marked down, it would have adversely affected lenders that are now coming back into a viable, positive situation. The interest rate market goes up and down, and I don't think we can adjust our loans or assets every time we have an up or down tic in the market, as long as they are good solid assets. That is the main thing, to determine the soundness of the asset that backs the loan.

So I wouldn't be in favor of mark to market on loans as such.

Chairman St Germain. Mr. Backlund.

Mr. Backlund. I agree that it is impractical today to put this into effect. There's too many problems out there, too much volatility in the financial industry to put something like this in effect.

The only way it could possibly be done would be to phase it in over a long period of time.

Theoretically, it is a great idea, but practically I agree it could not be done now.

Chairman St Germain. In other words, what you are saying is—I think all of you—that in the eyes of academia it might be very, very accurate, but in the real world—aren't those fellows lucky that they don't have to live in the real world?

Mr. Backlund. Yes, they certainly are. [Laughter.]

Chairman St Germain. To Mr. McEnteer and Mr. King. Both of you, naturally, are proponents of the dual banking system. But I would ask you this: Has either of your organizations recommended to State legislatures that legislation be adopted to require State government indemnification of the Federal insuring agencies for losses that arise from activities authorized by States for State-chartered institutions, but not by the Federal Government for federally chartered institutions?

I am sure you know whereof I speak, States like California and Texas and Florida.

Mr. McEnteer.

Mr. McEnteer. I am not sure I understand the question.

Chairman St Germain. The question is very simple, Mr. McEnteer.

I am referring to State-chartered institutions, where the State legislatures give powers and allow investments by the State-chartered institutions, that are not permitted to federally chartered institutions because the Federal insurance agencies feel that these activities are not the type that they want to insure or have their insured institutions engage in.

Now, if the States insist on going beyond the scope, so to speak, don't you think that the State therefore should indemnify the insuring funds?

Mr. **McEnteer**. Well, I think the State should have some reasonable latitude in being innovative as long as it is what we call reasonable, and some States have done that.

Pennsylvania hasn't done it as yet, but I would like to see some reasonable latitude for the commercial banks to have some powers that some of the Federal banks don't have but within a reasonable scope, and I think that can be done through the legislative process and through the State regulatory process.

Chairman **St Germain**. Mr. King.

Mr. **King**. Mr. Chairman, the State of North Carolina has obviously not taken any kind of legislative action to put such a program as you mention into place.

We do, and the legislature does, very much take into consideration its responsibility in regulating and legislating for the State-chartered institutions, and I would basically say that we have had some pretty broad investment powers in North Carolina for 3 or 4 years. It has not caused any major problem; it has not caused any major switch back and forth between State and Federal charters.

A lot of it comes back to the point of adequate supervision, and plus the industry itself in North Carolina is not nearly as aggressive as it is in some other areas. That helps an awful lot.

Chairman **St Germain**. It sure does.

Mr. King, are you or your organization completely satisfied with the number and quality of State S&L supervisors?

Mr. **King**. No, sir.

Chairman **St Germain**. Pardon?

Mr. **King**. We are not.

Chairman **St Germain**. You are not?

How about the State of California? Are you familiar with what has been happening there?

Mr. **King**. Vaguely.

Chairman **St Germain**. Where they have given some very broad authorities to their State-chartered S&L's?

Mr. **King**. Yes, sir.

Chairman **St Germain**. We will go-go S&L'ing?

Mr. **King**. Right.

Chairman **St Germain**. And yet they have reduced the number of supervisors and examiners?

Mr. **King**. Mr. Chairman, they have recently, as I understand it—and I am basically quoting from what I have recently read, like in the last 2 or 3 weeks—they have increased their examination staff to an agreed-on level that was agreed on with the Bank Board sometime last fall, and there appears to be some problems with that, that it is not adequate according to the Bank Board.

That is basically what I know about it.

Chairman **St Germain**. Has your organization taken any stand on this? Have they communicated or been in consultation with the State of California S&L supervisor?

Mr. **King**. Not directly as such that I am aware of.

Chairman **St Germain**. Well, just harken back to the testimony we received from Ohio's S&L supervisor telling us how wonderful their fund was a few years ago, and of course the facts now show that that was inaccurate.

I feel for the credibility of the National Association of State Savings and Loan Supervisors. I think when instances such as this arise you should——

Mr. King. Yes, sir.

Chairman St Germain [continuing]. Not hold back, but say, hey, listen.

Mr. King. We totally agree, and what we are trying to get into place—and it, very admittedly, is in its infant stage—is a program similar to what CSBS has recently—or has now in place, and that is a review situation for each one of the State authorities to determine adequacy or inadequacy and what they need to do to bring it up to standards if they are inadequate.

Chairman St Germain. You heard the other witnesses, and you heard me cite earlier the fact that we have had a great deal of testimony to the effect that the Federal agencies or regulators are having problems with staffing.

Mr. King. Yes, sir.

Chairman St Germain. And that being the case, certainly I think from what you just said, you agree that the States also have their obligations in this area?

Mr. King. Yes, sir. We have basically the same problems the Feds do, and that is our people, once they are trained and adequate, the good ones go into the industry where they can command a much higher salary and a lot better benefits.

Chairman St Germain. The States probably have worse problems, don't they——

Mr. King. Yes, sir.

Chairman St Germain [continuing]. Because the State legislators oftentimes don't understand how important this is?

Mr. King. Well, it is not so much that. Our State examiners are so much closer to the industry in a lot of respects and instances than the Federal examiners and the exposure is much greater. We do have some restrictions as far as the State legislatures are concerned.

Chairman St Germain. Mr. Levy.

Mr. Levy. Mr. Chairman, I just have to speak out for the State of Wisconsin.

For almost 1½ years the Federal Home Loan Bank Board has been accepting examinations by the State savings and loan department in lieu of Federal examinations. We have computerized monitoring. They are constantly tracking our records. They have computer models, and it is an ongoing process.

I think we have just an outstanding level of examination, and I guess what I am suggesting is, there will be differences across the country, but I wouldn't take the position that overall State supervision is lacking. In some cases it may be the role model.

Chairman St Germain. I think the position is that in many States—let's face it, Wisconsin is one of a few.

Mr. Levy. I would also add, though, we have heard a lot of discussion about compensation, and about staffing levels, and that the steps that the Bank Board has taken to move the examination procedure to the district banks is a major step forward. A lot of them pay competitive salaries.

Chairman St Germain. That should help substantially.

Mr. LEVY. I was just looking at the question of who pays for the examination. We pay for it, and we have just been notified, all the savings and loans, of 56-percent increase in the daily rate, from $160 a day to $250 a day, and an increase in the assessment of 45 percent to fund up what is being done.

In other words, this increased cost of supervision isn't going to be borne by the Government; it will be borne by the institutions. We pay for our examinations.

So, we are paying a higher amount to be supervised, and if we are running cleaner and better operations and our exams are more spaced out we pay less than the other fellow.

Mr. WYLIE. Would the chairman yield?

Chairman ST GERMAIN. Just let me finish on this.

As far as the commercial banks are concerned, it is a little different with the FDIC, isn't it? In other words, you pay based on the size of the institution, isn't that it, Mr. Cairns?

Mr. CAIRNS. We pay for the examination itself.

Chairman ST GERMAIN. You pay for the examination itself, but not on an hourly or daily basis?

Mr. CAIRNS. No, it is for the examination.

Chairman ST GERMAIN. Is it a flat fee based on the size of the institution?

Mr. CAIRNS. Well, I guess I really don't know.

Chairman ST GERMAIN. Mr. Backlund.

Mr. BACKLUND. I am sorry, I can't answer that. Maybe Mr. Edgerly can.

Chairman ST GERMAIN. Mr. McEnteer seems to know.

Mr. MCENTEER. You are asking about the FDIC charge for examination?

Chairman ST GERMAIN. Yes, sir.

Mr. MCENTEER. They don't actually make a charge for examinations. That comes out of their fee that they charge each bank the assessment fee.

In Pennsylvania we charge the full cost of examination for each bank, but the FDIC does not make a certain examination charge. So banks sometimes think they are having a free examination, which isn't quite true, but——

Chairman ST GERMAIN. It comes out of the insuring fund?

Mr. MCENTEER. It comes out of the insurance fund, out of the one-twelfth or 1 percent of their deposit fee, whichever it is.

Chairman ST GERMAIN. But that comes out of the overall insuring fund?

Mr. MCENTEER. Right.

Chairman ST GERMAIN. It doesn't come out of the insurance that institution X pays?

Mr. MCENTEER. No, it comes out of the overall——

Chairman ST GERMAIN. So isn't that added discipline on an institution if it has to be examined with more frequency because they have a number of classified loans? If that institution had to pay that extra fee, the board of directors certainly and the stockholders would get a little upset; wouldn't they, Mr. Cairns?

Mr. CAIRNS. Yes, and I believe, Mr. Chairman, that the Comptroller of the Currency charges a fee for the examination. You see, if you are a national bank, it is the Comptroller instead of the FDIC. So there are differences.

But your basic—I think your basic premise—that being that we should pay for the examination we receive and that that would add some discipline to this thing—I think is a very good premise. We would support it.

Chairman **St Germain**. Yes, thank you.

Mr. Wylie?

Mr. **Wylie**. Thank you, Mr. Chairman. That was a very interesting bit of information you elicited there.

I have a question that is somewhat related to that.

Mr. McEnteer, you argue that it should not be the role of the insurer to close an institution which is becoming insolvent. In other words—I understand where you are coming from—you think State-chartered institutions which are insured by FSLIC should be monitored by the regulator. In this case it is the State regulator.

How can the insurance agency, FSLIC, protect its funds if it can't close down an institution?

Mr. **McEnteer**. Well, we think that the insuring agency should be called in when a State regulator determines that there is a problem with either the S&L or the commercial bank. I am talking more about the commercial bank than I am the S&L.

We examine these banks, and we rate them as to their, you might say, CAMEL rating, and when we find one that we think is going to create a problem for the insuring agency, then we think that we should call in the insuring agency at that time and work with them to determine whether we can save the bank by working together or whether we have to work to some way phase it out of existence or close it.

We do think they have to be called in before the bank is failed. It has to be called in when we determine that it is in a failing position.

Mr. **Wylie**. I guess it's which comes first. Should the State regulator call in the FSLIC or should FSLIC call in a State regulator?

Obviously, you have to get together on it at some time or another. But who should be the initiator of the process?

Mr. **McEnteer**. Well, in Pennsylvania, we work pretty closely together. Fortunately, we haven't had many of the problems that other States have had. But we do cooperate very closely and we don't have any problems.

But I think that it's the primary regulator that should make the determination as to whether a bank should be closed.

Mr. **Wylie**. You don't have a private insurance fund in Pennsylvania, do you?

Mr. **McEnteer**. Yes, we have one.

Mr. **Wylie**. It's one of the States that still does have a private insurance fund?

Mr. **McEnteer**. We have one but the savings associations that are insured in Pennsylvania by private insurance are very small. There are about 68 of them; they're very small. And most of the larger ones, the ones that would qualify, are being requested to apply for Federal insurance.

Mr. **Wylie**. You're requesting that they apply for Federal insurance?

Mr. McEnteer. We're suggesting that they do, the ones that we think would qualify.

Mr. Wylie. You used the word "requested." I just suggested——

Mr. McEnteer. We don't request, we sort of nudge them, suggesting that they apply. Actually, the administration is proposing legislation to require all privately insured S&L's to apply for Federal insurance. Now, there's some of those that won't be able to qualify and they give the Department of Banking, which supervises the S&L's, certain leeway and time to phase these people out.

Now, whether this legislation will be successful in passing, I don't know. But, in the meantime, our private insurance corporation, which we have a lot to do with and help handle on a day to day basis, has proposed a resolution that will require that, in the future, all S&L's that reach the size of $5 million will be required to apply for federal insurance.

So we haven't had any problems in the State at all.

Mr. Wylie. Well, that's good. We've had a few in Ohio. [Laughter.]

Mr. McEnteer. And we had a few phone calls because of your problems, too. [Laughter.]

Mr. Wylie. Is your private insurance fund backed by the State?

Mr. McEnteer. No, it isn't. Not any more than it was in Ohio.

Mr. Wylie. OK. I have a feeling that some States have a better examination process than others, and that we can depend on some of the examinations. I think, maybe from what you tell me, that might be true in Pennsylvania. It might be true in Wisconsin. But we have to enact legislation which would apply across the 50 States.

Why shouldn't the FSLIC, the insurance fund, try to protect itself by being able to close State chartered institutions?

Mr. McEnteer. Well, I think that's the job of the primary regulator. The regulator that chartered these associations.

Mr. Wylie. I know I asked you that question once, but I was revisiting it and framing it in a little different reference.

Mr. McEnteer. Well, a State chartered association, or a State chartered bank is chartered by the State. So the State, as a primary regulator, I think should determine if and when an S&L or a bank should be closed.

Now one of the things we're concerned about is the FDIC seems to be more interested in protecting the Fund than they are in protecting the depositors, which is what the Fund was originally established for.

I was in the banking business in the thirties when the Fund and the FDIC was first started. And it started off with $2,500, then went to $5,000, then to $10,000 and is up now to $100,000.

There seems to be some interest in protecting the Fund, which there should be. But the real basic reason for Federal deposit insurance was to protect depositors.

Mr. Wylie. Well, if there isn't any fund, it's going to be difficult to protect the depositors unless you call on the full faith and credit of the Government and use taxpayers' money to do it. But, again, I guess it's a chicken-egg proposition.

I happen to think that the primary function is to protect the depositors and that the way you do that is to protect the fund or have money there if there is a run on a bank.

But Federal funds are involved here, albeit they come from premiums assessed on the financial institutions. But they're not State funds, they're not private funds, they are administered by a Federal agency and there is a Federal nexus.

Well, what do you think about my question, Mr. Levy?

Mr. Levy. I think that there's been a significant change in the last 6 months with the development of the Management Consignment Program. I think you've been witnessing a much more aggressive approach by the Federal regulators in stepping in and taking over State-chartered institutions.

Uniquely, we have a combination—and we think it's one of the strengths in the savings and loan industry, that it's all within a single agency—of the insurance function, the supervision function and the regulation function all combined into one regulator.

We now have 17 institutions that are operated under the Management Consignment Program. I think they have aggressively moved forward now that the tool is in place.

I think the question you're really addressing is the tradeoff between the responsibility of the insurance fund, which is at risk, and the right of the State which issued the charter to regulate its own institutions. There has to be a give and take, because it isn't easy for the deposit insurer to terminate insurance. It's a long, slow, process. I think it's 2 years to phase it out.

So they have to be in a position to step in and protect the Fund and act aggressively.

Mr. Wylie. Thank you. I think they do, too.

Professor Kane was here from Ohio State University last week, and he thought that we should go to a market value accounting system, Mr. Backlund; and there were others who said the same thing. At the time, it seemed like it wasn't a bad idea. More realistic than the cost basis, which you now use. You are opposed to it though? The market value accounting?

Mr. Backlund. I am not opposed to it in theory. I think it probably would have been great if we had done that over the years in our financial system, but we haven't done it, and, today, we are facing these great problems.

And, you know, our financial structure is the cardiovascular system of our great economy. And anytime you fiddle with it or change it, you do so at great risk. I just don't think now is the time to get into something that would be that disruptive.

Mr. Wylie. I was just told that the chairman asked the same question, which may mean that great minds run in the same path, and that you answered his. And so I'll read the response to his question, since it's already been asked.

Mr. Levy. If I could just add this: If we had had market to market accounting in place in 1981, late 1980, when prime hit 19, Fed funds were 21, the mortgage market topped 16–17 percent, we would have taken a 25–30-percent hit. You would have closed institutions all over the country, including many independent banks that had portfolios of fixed rate instruments.

It's one of those things that sounds good in the academic environment, but in the real word, it just doesn't work.

Now, over a long period of time, it may be something that we move forward and toward, but to talk about it today is just unrealistic.

Mr. **Wylie**. Well, I thought it sounded too good at the time.

Thank you very much, Mr. Chairman.

Mr. **McEnteer**. I think we have adjustable rate loans now that help the future of that situation. We have a period of increased interest rates in the future, then the adjustable rate loans will help take care of that, which we didn't have before. We had fixed rate loans all the way through. Cogent observation.

Chairman **St Germain**. Mr. Cairns, on page 9 of your statement, you call for statutory guarantee of a portion of uninsured deposits and a phase in of modified payoff insurance reforms.

Isn't that tantamount to saying that you are insuring uninsured deposits?

Mr. **Cairns**. I think we're saying there that we believe that the $100,000 level is the level where the depositor's interest should be fully protected. Above that figure, we think the depositor should be at risk.

Now, to move from where we are today to that, just like that, may cause some difficulties and market disruptions. Therefore, it may be important to——

Chairman **St Germain**. Mr. Cairns.

Mr. **Cairns** [continuing]. Phase that in.

Chairman **St Germain**. Mr. Cairns; we are there.

Mr. **Cairns**. You are where?

Chairman **St Germain**. We are there. In other words, when an institution is shut down, the depositors are covered up to $100,000. Then the other creditors and then the uninsured depositors, people with moneys over $100,000, have to wait for their money; do they not?

Mr. **Cairns**. Do they?

Chairman **St Germain**. Well, of course, they have to wait until the assets are sold off. In Penn Square and Golden Pacific people are still waiting to get the balance of their funds.

So you're not moving from one to another like that.

What you suggest in your testimony, is that we give a statutory guarantee to uninsured depositors that they don't have now.

Mr. **Cairns**. Well, Mr. Chairman, I think part of the reason that we're having these discussions is because there is confusion in the marketplace as to what really is the case.

You're technically correct. Deposits of over $100,000 are not insured. But, we have the Continental situation, which sent a big signal out that caused that to be in question in the minds of the public. Whether it's in question in law or not is another issue. But in the minds of the public there's a question. Old discussions about are you too big to fail and all that comes from that.

We think, as we've said before, that it ought to be as you outlined, ought to be the way the law is. If you're over $100,000, you are at risk, you ought to be at risk.

If—and we think that should be clarified. And through that clarification, we believe all the other disclosure, public watching of the institution and so forth would fall out of that and be very healthy for the industry and healthy for the strength of the funds that are involved.

The question comes, however, were you to do that immediately, where you make it clear the modified payout was the way that a failed bank was to be handled in the future, as to whether or not that would cause some disruption in the marketplace that would be a fallout.

Chairman ST GERMAIN. Mr. Cairns, let's go back 15-16 years. Back then, about 15 years ago, were you in the banking business?

Mr. CAIRNS. Yes.

Chairman ST GERMAIN. And in what capacity?

Mr. CAIRNS. Fifteen years ago, I was in charge of all of our operations.

Chairman ST GERMAIN. You were in charge of?

Mr. CAIRNS. Of the operations part of the bank, I believe, at that time.

Chairman ST GERMAIN. Well, I guess you weren't in a position to listen to the ABA testimony back then. But I heard. Now let me tell you about their testimony.

We were having hearings on increasing deposit insurance. Now, the ABA came up here and said: No.

Do you know why they said no?

They said: Because, if you increase deposit insurance, you encourage sloppy management. By keeping deposit insurance low, people with funds over and beyond that which those deposits are insured are going to exercise more judgment and make their decisions based on the quality of management.

In other words, the ABA said: The lower the deposit insurance, the higher quality of the management of these institutions.

Now we're up to $100,000. But, you see, I find this hard to swallow in view of past testimony from the ABA.

Mr. CAIRNS. I think I'm not making myself clear, and I apologize for that. Let me begin again.

Chairman ST GERMAIN. You made yourself very clear. You said that the transition would be too fast because the perception after Continental is that deposits over $100,000 are still protected.

Mr. CAIRNS. If that's what I said, I didn't make myself clear.

Chairman ST GERMAIN. Well, then, start all over again.

Mr. CAIRNS. All right, let's start over again.

To begin with, we think the $100,000 is the place you draw the line and anybody over that amount should be at risk. And we almost can stop right there. We don't think that's happened. We think that it's unclear in the marketplace as to what will happen if you are a depositor, particularly of a very large bank.

And for that reason, we think some clarification should be made. We call it the modified payout plan. We suggested that the institution isn't closed immediately and there's some trusteeship, it shouldn't make any difference. Those people with those deposits over the $100,000 should be at risk.

That we could stand right there.

We go on to say, however, if that's impossible, for reasons that we don't subscribe to, but if it is impossible and it can't be achieved, then, as an alternative to get to that point, we would suggest some phasing to get to that point.

But we don't alter our position that it ought to be no more than $100,000 that's insured. And we would prefer that to happen immediately.

Chairman **St Germain**. Well, maybe we read your statement wrong. You see, we thought that what you were saying was that there should be a statutory guarantee for a portion of the uninsured deposits; that is, those deposits over $100,000.

Mr. **Cairns**. I don't believe that was——

Chairman **St Germain**. Well, if that's the case, then fine.

Now, Mr. Edgerly, on page 5 of your statement you point to the risks inherent in intraholding company transactions to the insuring funds in the Federal Reserve. For this, we thank you and also comment on the necessity of enacting H.R. 20.

Now, do you have any idea as to how large the risk is that you're discussing in that particular section of your statement, dollarwise? Roughly?

Mr. **Edgerly**. I can only give you the aggregate numbers which we have in the statement of the daily volumes. They are very large. The experience of banks that has been measured, in the work of the association in which interday overdrafts have been measured the total overdrafts of given banks have been stated as a multiple of capital.

But the point that you're focusing on page 5 would be the size of transactions of a particular institution and, obviously, that can range over a very wide spectrum. But it can be very large. It can be in the hundreds of millions of dollars.

We are talking about large dollar payments. When you look at the securities industry, for example, and the very large movements of securities, we're talking about big numbers for particular transactions.

Chairman **St Germain**. Mr. Rutland, you advocate risk-related capital rather than risk-related premiums. When you discuss how you would set the capital levels, it seems to be very, very similar to what other people have described on how to set risk-related premiums.

Don't both of these proposals, as far as how you set the levels, present problems in measuring the risk?

Mr. **Rutland**. Yes, they do. The risk has to be measured, however, and we set forth in our task force report a couple of alternatives. We believe that the CAMEL rating is one way of getting there and the FHLBB has a similar rating system in place.

Certainly, these can be refined more and we would be glad to do that and submit something further.

Chairman **St Germain**. Please do. We need all the help we can get.

Mr. **Rutland**. We feel very strongly, however, that the variation should be in capital as opposed to deposit insurance premiums, because it provides further protection. For example, if an institution wants to take risks, it puts up its own capital ahead of the Government. Therefore, that capital would be used up in case the investments went bad before there would be any call upon the insurance fund.

We suggest that is a bigger deterrent to taking risks than it is to charging an additional premium.

Chairman **St Germain**. Your colleague from Wisconsin would like to be heard.

Mr. **Levy**. I said earlier that we supported the net worth related risk-based premium, but maybe there's a departure because we're not thinking of it along the lines of CAMEL ratings.

In our own deliberations, we've approached it from activity levels and types of activity. We've examined different types of powers that institutions exercise and tried to see if we could come to some understanding of the risks and how the risks differ, and then tried to correlate additional net worth standards for certain kinds of activities.

I think that if we're really talking about risk-related premiums, by the time you get to the CAMEL ratings, it may be, you know, the CAMEL's nose is already under the tent. I mean, the activity is already in place. If it's going to deter conduct, or more importantly, going to protect the Fund and all of the other people who pay into the Fund, I think that we're talking about setting those standards at the front end before the activity commences.

Chairman **St Germain**. Mr. Rutland, in your statement you say the Federal Home Loan Bank Board requires examinations once during a 36-month cycle; is that accurate?

Mr. **Rutland**. Yes. Well, that came out of our discussions with members of the FSLIC, and that was the schedule that we were told was in existence.

Chairman **St Germain**. You don't think it is closer to 12 months?

Mr. **Rutland**. No, it is not closer to 12 months.

Chairman **St Germain**. Well, Mr. King wants to speak.

Mr. **King**. Mr. Chairman, I might be able to shed a little light on that. It is not 36 months, obviously, between visits from the examiners from the Federal Home Loan Bank Board. They in a number of the districts—and our district is one of them that we sit in in North Carolina—they set as a maximum of 36 months doing a full-blown regular examination.

We do, and on a joint basis in most cases, go in at least every 12 months and do what is called an annual examination, which is a shorter version of a full-blown examination. But at least once every 3 years a full-blown, full-scale examination is done.

Chairman **St Germain**. You say at least, but by the same token it could be every 18 months.

Mr. **King**. Sure.

Chairman **St Germain**. Twenty-four months.

Mr. **King**. And there are situations that the examiners are in every 6 months or every 9 months, depending on what the situation and the rating of a particular institution is.

Chairman **St Germain**. Do you still want to be recognized, Mr. Levy?

No, I didn't think so.

Mr. **Levy**. He clarified it.

Chairman **St Germain**. I tell you, we have a member of the full committee here, who is not a member of the subcommittee, but who is very, very interested in the subject matter at hand. We are very impressed by his attendance at these hearings. In addition, we are very happy to ask Mr. Carper if he has any questions.

Mr. Carper. Yes, I do. Thank you, Mr. Chairman.

I would like to follow up on the last point that the chairman was pursuing there, and before I do I just want to thank the members of this panel for your testimony. It is good to have a number of you back. It is good to see some of you for the first time.

Mr. King, I would like for you to take just a moment, if you will, and I am thinking of the relationship between the State supervisors, the State examiners, and the Federal examiners. I always perceived the State as an early warning system, and you are out there on at least an annual basis, can find out what their problems are on an earlier timeframe than can those people who may be coming in every 36 months or so.

I would like to just ask you to tell me about three things: First of all, the turnover that you have experienced in your own State, North Carolina, in terms of hiring and retaining, keeping supervisors; second, if you could give us some idea of what you pay them, the starting salaries and what the range is; and, third, some idea of the kind of training that your people undergo; and then, lastly, if that is representative of those features of other States throughout our Nation.

Mr. King. Our turnover rate is not as high right now or for the last several years as it has been in the past. Some 2½ or 3 years ago, we faced really a crisis because we did not have the experience level in our examination staff that we really would liked to have had. We made a conscientious effort to fill vacant examiner positions for a period of 1½ years with experienced people, either experienced examiners or people experienced in the financial industry either in banking or with S&L's. Primarily, it wound up being in banking.

As a result of that, the average age of our examination force now is probably close to 50 years old. The average experience level with our department probably is closer to 8 or 10 years. We have a former State banking examiner; we have two former FDIC examiners, you know, this type of thing.

Mr. Carper. Can you quantify the turnover? You said the turnover today isn't what it was 3 years ago.

Mr. King. Our turnover—up until that time our turnover would run anywhere from 25 to 40 percent a year in examination staff.

Mr. Carper. And today it is roughly?

Mr. King. Today it is—well, we basically have not had any turnover in the last 12 months—oh, I take that back. We have lost one examiner, but we did not fill the position.

Mr. Carper. And again what do you attribute that change in turnover to? Higher salaries, better working conditions?

Mr. King. Again, I think it was the type of people we went after. You know, the problem we have, you have and the Bank Board has the same problem. You take young people out of college. They are for the most part very aggressive, the type of individuals you are looking for, trying to get ahead. You bring them into our systems and give them 2 to 5 years experience in all phases of financial institution exposure, and, you know, depending on the individual in a lot of cases but in almost every case they are worth, you know, anywhere from 25 to 50 to 75 percent more than we are capable of paying them.

Mr. Carper. Can you give us some idea of what your salary range is for people you first hire?

Mr. King. Well, our starting salary for an examiner right out of college right now is about $20,000 a year. Our most senior examiners now can make up to about $45,000 a year in North Carolina. It is a pretty good range. It does not compare right now with the new system that the Federal examiners are under, and we are going to make a concerted effort to get that changed on the State level.

Mr. Carper. The salaries that are paid your examiners, is the money drawn from a general fund or is it drawn from a special fund created by fees that can be only used for this purpose?

Mr. King. Right, we are special fund agencies, very similar to the description Mr. Levy made while ago. Our institutions pay a supervisory fee and an examination fee, and that is what we operate on, so that the institution is footing the bill.

Mr. Carper. Can you take a moment and tell us about the kind of training that your people undergo—new hirees, new to the business, as well as people on an ongoing basis who have been with you for some time?

Mr. King. We have basically taken the position, as have a number of States, that there is no need to reinvent another wheel. The Bank Board has had a very adequate training system in place. That has been available to the State examiners, and we have full well taken advantage of it.

They have a new examiner training school, appraisal school, senior finance school, and various and sundry other training programs.

The biggest problem we are facing now as a State—and all the other States are facing it, too—is that with the changes that have taken place recently the cost of that training is about triple what it has been in the past. It has, you know, been costing about $800 to $1,000 to send a new examiner to training school. Now it is going to cost in excess of $3,000.

Mr. Carper. I don't know if this is a fair question. If it isn't, just tell me. But you are from North Carolina; you are clearly familiar with the situation there within your own shop.

Can you make some general statements about other States, particularly in the areas we have discussed—training, compensation, turnover?

Mr. King. I think for the most part—you know, you first of all need to understand that there are—and I don't know what the percentage is, but I would estimate maybe 10 to 12, 14, 15 States that have strong State-chartered systems, and I think in those States there is a very genuine and concerted effort to take a primary role in supervision and regulation.

And then you have a larger percentage of the States that fall in, you know, a medium range, where the number of institutions or the total assets of the savings and loan industry in a given State is dominated by federally chartered institutions, and I think in those situations the States take a less dominant role as far as supervision and regulation. And then there are a few States that have very few State-chartered associations and defer primarily to the Bank Board and the FSLIC examiners to provide that supervision and regulation.

Mr. CARPER. All right. Thank you very much for your responses.

Thank you for the chance to ask the questions, Mr. Chairman.

Chairman ST GERMAIN. The Chair would like to, on behalf of all the members of the subcommittee, thank the panel, particularly for your cooperation—oh, I am sorry, George, I didn't see you come in.

Mr. WORTLEY. Could I get in just——

Chairman ST GERMAIN. No, no, that is all right. I just want to particularly thank you for your cooperation and the manner in which you abbreviated your statements so that we could get all of the statements in and get to the questioning period. You all did a great job, and we are most gratified.

Mr. Wortley.

Mr. WORTLEY. Thank you, Mr. Chairman.

I regret that I haven't been here for the entire hearing, but there are just a couple of points that I noticed in the testimony.

Mr. McEnteer, you advocate the reducing of the insurance coverage from $100,000 down to $40,000. I think it is a pretty good idea.

But in view of the fragile perception of the system today couldn't that lead to a run on our banks?

Mr. McENTEER. I think it would be very difficult politically to reduce the insurance coverage. But, it was a suggestion that we had to increase market discipline, to have people become more aware, to look at the institutions themselves, to the soundness of the institution rather than to just count on insurance and deposit their money wherever there is a sign up that says we have insurance.

I have heard some testimony. I was around when this was increased from 40,000 to 100,000, and I heard some of the debates, and I didn't agree with it then, and I just think it would help with this market discipline that we hear so much about now to have people be more concerned about the management and the safety and soundness of where they are putting their money rather than just depend on—we will put it any place and say, well, it is insured so I don't care about the management.

Mr. WORTLEY. Do you think we could go back to the lower figure in the reasonably near future without creating a crisis?

Mr. McENTEER. I think it would be very difficult to do that, but it is a suggestion, and if somebody can determine how to do it, it would be quite an accomplishment, I think.

Mr. WORTLEY. If we could do it, you would support it?

Mr. McENTEER. I would support it if it could be done.

Chairman ST GERMAIN. Would the gentleman yield?

Mr. Barnard asked a similar question yesterday, and I meant to say, but didn't get around to it, that Mr. Barnard has his own program and this station does not take responsibility for what he says on his program. [Laughter.]

I don't want people writing to me, yelling about the reduction.

Mr. WORTLEY. This would probably be an imprudent time to attempt to accomplish something like that.

Mr. Cairns, you mentioned that the ABA's Commission on Safety and Soundness has already determined that in a competitive environment of greater freedom maximum reliance should be placed upon market discipline and self-regulation is preferable to more government regulation.

But experience over these past few years has shown us that fraud and mismanagement has been to a large part responsible for some of the bank failures that we have had.

How can the industry expect a market discipline to replace the self-regulation of these problems?

Mr. CAIRNS. Well, in the case of fraud I am not sure that market discipline can help us a great deal there. There may be some things we can do that would perhaps show up fraud more quickly than has happened and thus reduce the effect of it.

But fraud is fraud, and wherever it is spotted. It will happen. It is just too big a world not to, I guess, and when it happens we think that movement should be swift and the institution be closed and remedies should be taken.

In terms of how can the industry self-regulate itself, we are studying that right now, and as I mentioned, we have a task force that is working on it. It met yesterday. We are not prepared yet—we haven't really come to any conclusions. We have got quite a bit of material surfaced, and I at this point have some high hopes that there will be some suggestions made that will have merit and the industry will be able to do something along this line.

But I don't think that by itself is enough. I think it takes a combination of lots of things to manage and supervise this industry, which is special and requires constant fine tuning and thought.

Mr. WORTLEY. Do you think the examiners have been deficient?

Mr. CAIRNS. Sufficient?

Mr. WORTLEY. Yes.

Mr. CAIRNS. No.

Mr. WORTLEY. Have the examiners themselves been deficient?

Mr. CAIRNS. Deficient?

Mr. WORTLEY. In ferreting out——

Mr. CAIRNS. Yes, I think they have.

Mr. WORTLEY. What is your recommendation—a better course in how to examine a bank or more examiners or more frequent examinations or what?

Mr. CAIRNS. Well, the chairman asked us that question earlier, and I believe we are going to all respond to that in writing, but just a couple of highlights.

I do think more market salaries to retain people, I think more money committed for training of those people, I think more computer usage to statistically analyze the condition of banks are a place to begin but there is more to that, and we are looking forward to the opportunity to respond to that directly in writing.

Mr. WORTLEY. Yes, Mr. Backlund.

Mr. BACKLUND. Could I comment on that?

I made some remarks earlier, probably when you weren't here, about depoliticizing the regulatory agencies so that they could react more quickly to some of these tough situations.

But just one other thing I wanted to mention in view of the questioning about examiners. I think one of the resources that we have that hasn't been used, at least to my knowledge, are retired bankers. Experienced retired bankers have a great deal of wisdom. We might tap that resource because when you get the younger examiner in there without having the experience out in the field, even though he has been trained, there is a lot there to be desired, and possibly that could be looked into.

Mr. Wortley. You are recommending that retired bankers go to work for the regulators?

Mr. Backlund. I think it has great possibilities. In fact, in our own little banks in our auditing crew, we use retired people very effectively because they have that wisdom that comes with age.

Mr. Wortley. I can think of a lot of bankers who have retired lately that I wouldn't want them to be checking the books. [Laughter.]

Mr. Backlund. Well, I am talking about the middle management people.

Mr. Wortley. I understand.

Mr. Backlund. That type of person has the kind of experience we need.

Mr. Wortley. Your point is very well taken, and I thank you, Mr. Chairman.

Chairman St Germain. Mr. Backlund, I didn't know, I can recall when you were working for $300 a month and $10 a day——

Mr. Backlund. Right.

Chairman St Germain [continuing]. Including gas? [Laughter.]

Are you looking to go back?

Mr. Backlund. Well, not really. [Laughter.]

No. A few weeks ago in my travels a retired banker did come up to me and suggest this at a convention, and I thought it was an excellent idea.

Why do they have these young, inexperienced bankers out there when there are people who are bored and don't really feel like they are doing things worthwhile who would like to do this?

Chairman St Germain. Well, you know, Mr. Levy, it is not all that bad.

What is the name of the group with SBA? The retired senior volunteers?

Mr. Wortley. The SCORE group or something.

Chairman St Germain. Pardon?

Mr. Wortley. The SCORE group? Is that what they call them?

Chairman St Germain. They go out and really do a great job of helping small business people straighten out their problems. They give them a lot of advice, and it could well be that there are some. You know, not everybody likes to golf or play Trivia Pursuit. If you keep busy you live longer and you stay slimmer. I take a look at my father. He is 83 years old, and he was so upset with himself for having retired when he was 77 that he got himself a part-time job. He wanted to get the heck out of the house. [Laughter.]

Mr. Levy, go ahead.

Mr. Levy. I wasn't shaking my head at that. That makes a lot of sense.

But in the savings and loan business, I think the problem we have had in supervision is that the business has been going through major changes. It is getting far more complex than it was, and I think that the training that was alluded to here is really critically important. You might have a savings and loan man who had been in the business and been out retired for 5 or 6 years to come back today as an examiner and look at the way an institution operates and the things they are doing, and it might be a totally foreign environment for him.

Chairman St Germain. By the same token, there is nothing that says that Mr. King couldn't send that man to the training school.

Mr. Levy. It is the training, I think, that is really the critical——

Chairman St Germain. Sure, to update him or her by the way.

Mr. King. Mr. Chairman, about 18 months ago we took advantage of just exactly this situation. A gentleman that was on the Federal Reserve Board staff here in Washington and had been in that system for some 30 years retired and wanted to move South, if you will, felt like he was 55 years old, felt like he still had some good years left, and I cannot tell you how much——

Chairman St Germain. Fifty-five. He has got a lot of good years left, Mr. King.

Mr. King. Absolutely. [Laughter.]

And I guarantee you he has given us a tremendous shot in the arm and boost as far as our capabilities and the background and ability that our agency has at this point. He has just been invaluable.

Chairman St Germain. Mr. McEnteer.

Mr. McEnteer. Mr. Chairman, I would like to put in a plug for the Pennsylvania Department of Banking. [Laughter.]

Our turnover comes mostly from retirements. The average length of service for our bank examiners is about 12.5 years and the savings and loan examiners runs about 15 years.

We have a good educational program. We take advantage of the CSBS educational programs at all levels of examiner skills from entry level into senior examiners. CSBS now has a new educational foundation started to educate all banking examiners in all sections of the country, which I think it is a very sound educational program, and we take advantage of it. The programs are being filled up more every year, and that is why we had to start this educational foundation because we couldn't afford through the dues of the associate members to support the schools any longer from those dues. So we started a new foundation, which is now in the process of raising funds to keep this on a perpetual basis.

I would like to get back to—Mr. Wylie who asked me why I thought that the States, the primary regulators should close the banks and not the FDIC.

I think that the reason for that is that we have a broad public interest in our State. It is a traumatic experience to close a bank for a community and the individuals involved. Hopefully it would go down to the last moment before we would decide to close a bank. Hopefully we would not close it early on in order to conserve some assets for the insurance fund.

So I think that we can determine in our own State pretty much how it is going to affect the community, what the results will be if that bank fails, and we do our utmost to try to keep that as an ongoing bank as long as we can. When we know that it is going to fail, then we take the action necessary.

Chairman St Germain. Staff just reminded me that in FIRICA of 1978 I included a title on the bank council. One of the functions of that bank council was to improve the examination process, and we are going to check with them and see what they have been doing recently. Unfortunately, when you get involved in these things, you sometimes lose sight of the fact that we already have legislation in place on that very point.

Gentlemen, I do hope that you will leave here this morning, or this afternoon, with a sense of accomplishment because you have indeed been very helpful to the subcommittee, and for that we are grateful. You yourselves should be very grateful and feel as though you have made a real fine contribution.

Mr. Cairns, I bet you had a good time today. We didn't have any confrontation. [Laughter.]

No, he was very helpful, really and truly. So on behalf of all the Members of the subcommittee, I say thank you.

I have a number of questions that I am going to send to you. In addition, there are a few I would like each and every one of you to address. We will send them out to you, reconfirming that which was said during the hearing so that we don't let anything fall between the boards. This is just too important.

So again thank you kindly. The subcommittee stands in recess until the call of the Chair.

Mr. CAIRNS. Thank you.

[Whereupon, at 1:30 p.m., the subcommittee was recessed, subject to the call of the Chair.]

[Letters of invitation to witnesses of this day's hearing and a statement of Charles W. Filson on behalf of the International Share and Deposit Guaranty Association, follow:]

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TOBY ROTH, WISCONSIN

September 20, 1985

Mr. Phil Corwin
Senior Federal Legislative Representative
American Bankers Association
1120 Connecticut Ave., N.W.
Washington, D.C. 20036

Dear Mr. Corwin:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on October 3, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

1. Modified Payoff
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Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv

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TOBY ROTH, WISCONSIN

September 20, 1985

Mr. B. F. Becklund, President
Independent Bankers Association
1625 Massachusetts Ave., N.W.
Washington, D.C. 20036

Dear Mr. Becklund:

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Chairman

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WASHINGTON, DC 20515

September 20, 1985

Mr. George King
National Association of State
  Savings and Loan Supervisors
1001 Connecticut Avenue, N.W.
Washington, D.C. 20036

Dear Mr. King:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on October 3, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

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Fernand J. St Germain
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WASHINGTON, DC 20515

[illegible]

September 20, 1985

Mr. George P. Rutland
National Council of Savings Institutions
Suite 400
1101 Fifteenth Street, N.W.
Washington, D.C. 20005

Dear Mr. Rutland:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on October 3, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

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Sincerely,

F St Germain

Fernand J. St Germain
Chairman

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NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

September 20, 1985

Mr. Gerald Levy, Vice Chairman
U. S. League of Savings Institutions
1709 New York Avenue, N.W.
Washington, D.C. 20006

Dear Mr. Levy:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on October 3, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

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Fernand J. St Germain
Chairman

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NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

September 20, 1985

Mr. Ben McEnteer
Conference of State Bank Supervisors
1015 Eighteenth Street, N.W.
Washington, D.C. 20036

Dear Mr. McEnteer:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on October 3, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

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Sincerely,

FJSt Germain

Fernand J. St Germain
Chairman

FJStG:dDv

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SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
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September 24, 1985

Mr. William S. Edgerly
Association of Reserve City Bankers
1710 Rhode Island Avenue, N.W., Suite 500
Washington, D.C. 20036

Dear Mr. Edgerly:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on October 3, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

1. Modified Payoff
2. Subordinated Debt Capital
3. Risk-related Deposit Insurance Premiums
4. Risk-related Capital Requirements
5. Insurance Fund Recapitalization
6. Insurance Fund Merger
7. 100% Deposit Insurance Coverage
8. Reduced Deposit Insurance Coverage
9. Increased Disclosure
10. Intensified Supervision
11. Market Value Accounting
12. Private Deposit Insurance
13. Brokered Deposit Restrictions
14. Insurance Premiums on Foreign Deposits

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building twenty-four hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing record, and if delivered when requested, the statement will be made available to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv

STATEMENT OF

CHARLES W. FILSON

ON BEHALF OF

INTERNATIONAL SHARE AND DEPOSIT GUARANTY ASSOCIATION

BEFORE THE

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

ON

COOPERATIVE AND FEDERAL SHARE INSURANCE
October 3, 1985

Chairman St Germain and members of the Committee, there is good news concerning not only the Federal Share Insurance fund but also the Cooperative Share Insurance funds. Through your support and the support of the entire committee, the National Credit Union Share Insurance Fund (NCUSIF) was recapitalized in January of this year. As you also know, the NCUA patterned its recapitalization plan after the operational models in place at the cooperative insurors. All of the critical ingredients in the plan came from the cooperative insurors including: the one percent withdrawable capital deposit; the option of waiving the premium; the annual report with external CPA audit; and, the payment of a dividend on the deposit.

We feel that it is most important to keep these facts in mind. Credit unions are different; their history is different. The differences have been the strength of the system. It is a cooperative movement. The cooperative insurance pre-dates by over 10 years federal insurance and was an important impetus for the creation of the federal credit union insurance program.

Cooperative credit union insurance does work. In the attached 1985 IS&DGA Yearbook you will see statistics about these funds' performances. The reason for these results is partly structural and partly individual performance. The fourteen private funds are closer to the action, have credit union representatives as active participants in their organizations, and have incentives to find the best solutions to problems.

The immediate question people raise is, will the public accept private insurance? I would answer that federally managed and mandated insurance is required in no other areas of our life or commerce -- not to insure our lives, our homes, our autos or even to a large extent our retirement funds. When periodic economic downturns occur, federal insurance has become the excuse for trying to mandate federal legislative or regulatory solutions to marketplace challenges. We take this approach in no other area of our economy. Federal insurance instead of a last resort safety net, or of one option among several, becomes the principal factor controlling the major business decisions for thousands of financial organizations.

As further evidence of each cooperative insurors determination to adhere to the highest possible standards of protection for their member credit unions, the members of IS&DGA have unanimously adopted the set of standards submitted with this testimony. They recognize your interest in the development of such standards Mr. Chairman and would welcome comments from you or the members of the committee.

We could go on for hours about the benefits of dual chartering and the availability of insurance options for credit unions, but we believe that this committee is aware of the facts and history on this issue. We are sure that the information contained in the Annual Yearbook of IS&DGA and the adoption of minimum standard should justify this committees continued support for the Cooperative share insurance for credit unions.

As a closing thought, I would like to leave this committee with a recommendation. Extend options. If private insurance works for state chartered credit unions why not give federal credit unions the choice as well. I think options are essential for maintaining a responsive federal system. For the choices opened in a dual chartering system are critical to every credit union's well-being -- whether federally or state chartered. Private insurance funds make dual chartering a reality and in doing that, give all credit unions a more responsive system of regulation and insurance.

Thank you. I will be happy to provide the committee with any additional information.

International
Share &
Deposit
Guaranty
Association, Inc.

Callahan & Associates
4853 Cordell Avenue
Suite 8
Bethesda, Maryland 20814
(301) 656-8890

Standards for Cooperative Credit Union Share Insurance Corporations

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PURPOSE:

The following IS&DGA Standards have been implemented to establish the minimum operating procedures for prudent management of cooperative credit union insurers.

These Standards benefit the insurance corporations and their members by facilitating a system of share insurance that is cost effective, financially sound, and responsive to changing member needs. These Standards are the minimum practices to be followed. The financial, geographic and legislative history of each corporation will determine the specific methods a Fund uses to meet each requirement.

Through the Permanent Standards Committee compliance audits and other IS&DGA initiated self-regulating efforts, the financial integrity of the whole insurance system is monitered and enhanced to meet changing circumstances.

A. CHARTERING AND ORGANIZATION

- Each share insurance corporation shall be duly chartered under appropriate state authority and authorized to do business pursuant to such charter.

- The insured credit unions of such corporations shall have an opportunity to elect directors of the corporation and to influence through such means the affairs of their organization. The Board and insured members shall have the ability to nominate and install directors who would not be employees or officials of such insured institutions and who would provide professional expertise, oversight and objectivity, as may be needed, in the conduct of the insurer's affairs.

The Organization of Cooperative Credit Union Insurers

B. SUPERVISION AND REGULATION

- The Share Insurance Corporation shall be supervised by a designated state authority. Such supervision shall include the requirement for the corporation to be available for at least annual field examination. The written report of such examination shall be made available to supervisory authorities in other states in which the corporation does business.

- The Share Insurance Corporation shall maintain continuing communication and coordination of actions with the state supervisory authorities about the condition of the insured credit unions.

- At the fiscal year end the Share Insurance Corporation shall file a financial statement with the supervisory agency in any state in which the corporation does business.

C. AUDITING AND FINANCIAL REPORTING

- Each Fund shall be audited at least annually by an independent CPA firm in accordance with GAAP. The results of this audit including the auditor's opinion shall be filed with the supervisory agency in each state where the Fund does business and shall be made available to the insured members and all other interested parties as soon as available at the completion of the audit.

- Each Fund shall issue at least quarterly, company prepared financial statements, on an accounting basis consistent with the annual audited report. These interim statements shall include key financial ratios so as to enable users of the statements to monitor overall trends.

- Each Fund shall publish an Annual Report of its operations including audited financial statements and such Report shall be available to the public.

D. FINANCIAL STANDARDS

1. CAPITAL

- Each Fund shall have a capital base composed, at a minimum, of deposits from members and retained earnings. The entire capital base shall be available to absorb the costs of operation including the expenses of insured losses. The terms of withdrawal of deposits, if allowed, shall be clearly stated in writing. Each Fund shall have the ability to modify the level of capital as circumstances require. Each Fund shall have a minimum of 1% of net worth to insured savings; or an amount mandated by state law.

- Each Fund shall have the authority to assess a premium on at least an annual basis that may be accounted for as income and/or capital;

- Each Fund shall have the authority to increase capital above the minimum deposit or premium requirements in extraordinary circumstances (for example a second premium assessment or an increase in the capital base).

2. LIQUIDITY

- Each Fund shall have internal liquidity management practices and external lines of credit in place to meet each level of contingency in operations. These needs include routine daily transactions, short term financial assistance to insured institutions, payments for assisted mergers and reorganizations, long term financial assistance (over 1 year) and funds for liquidation and payout of shareholders. External lines of credit, equal to at least 10% of the insurer's largest credit union, shall be from different sources, confirmed in writing, and periodically reviewed for overall adequacy.

E. RISK UNDERWRITING AND MONITORING

1. Eligibility for Membership

- Each Fund shall have written procedures for reviewing all applications to determine that the applicant is an acceptable risk (eligibility standards) and that there is authority to deny insurance or to require changes if the applicant presents a below average or deteriorating performance in any area of critical underwriting criteria.

2. Monitoring Insured Performance

- Each Fund shall receive, at least quarterly, financial reports on each insured institution in sufficient detail to monitor critical financial trends on both an individual and comparative basis. These trends include earnings, solvency, growth, investments, loan delinquency and concentration, and liquidity. An overall rating using a system of analysis such as CAMEL may be used to summarize credit unions trends.

- More frequent reports shall be required from insured institution as may be determined by risk; these reports shall be shared with the credit union's regulator for suvervisory coordination;

- Each Fund shall have agreements to receive, in a timely manner, examinations and other supervising reports of its insured institutions.

- Each Fund shall continuously review all data and identify the relative risk exposure represented by each insured institution;

- Each Fund shall have the authority to conduct periodic field examinations of its insured credit unions.

3. Managing Risk Concentration

- Each Fund shall maintain a profile and analysis of risk concentration as measured by insured shares per institution as a multiple of the insurer's capital;

- The insurer should monitor this concentration and provide through reinsurance commitments or other contingency plans a means of responding to significant problems in the Fund's largest insured institutions.

4. Enforcement of Insurance Authority

- Each insurer shall have contractual or statutory authority to change practices in any institutions that represent a threat to the solvency of the insured institution or the insurance fund. Such methods may include termination of insurance, removal of employees or officers, enforcement of operating restrictions or covenants, or such other means as may be appropriate including individual premium or capital deposit adjustments (risk rating).

F. COMPLIANCE WITH STANDARDS

- Each insurer will be examined by an independent audit committee at least annually and a written report issued to the management and the Board of the insurance

Fund concerning the degree of compliance with the above standards. The audit committee will include a representative of:

- -- Another (non-competing) IS&DGA member;
- -- An independent CPA firm;
- -- State Regulatory Authority;
- -- IS&DGA management

● Each Fund's annual independent audit shall also include a review of compliance with these standards and the results therefrom included in a separate auditor's letter.

● Copies of each review and management's reply, if any, will be sent to the appropriate supervisory authorities.

G. REVIEW OF STANDARDS

● A standing committee of IS&DGA members, and other parties as appropriate or necessary, shall be appointed by the Chairman of IS&DGA to moniter these standards.

● At least annually the standards committee of IS&DGA shall review the requirements in place, the state of compliance by members, and the need for change. In the event of disagreement among the membership about a standard, the final decision will be made by the standards committee.

H. CORPORATE AND PROFESSIONAL DEVELOPMENT

● Each insurer shall maintain a corporate plan including financial budgets, organization goals and training. In addition the Fund shall work with its insured institutions and other IS&DGA members to develop new tools and techniques of supervision and to share resources for mutual self-help.

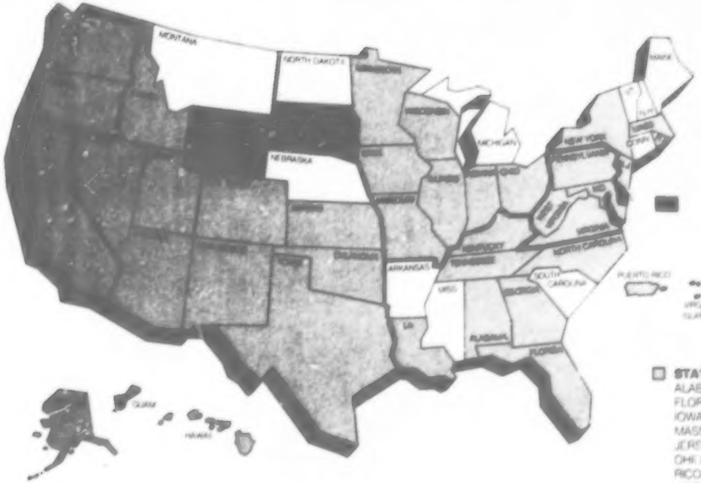
1303

International Share & Deposit Guaranty Association

The Organization of Cooperative Credit Union Insurers

1985 YEARBOOK

INSURANCE OPTION STATES


MONTANA
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NEBRASKA
MICHIGAN
NEW YORK
ARKANSAS
MISS
SOUTH CAROLINA
MAINE
PUERTO RICO
VIRGIN ISLANDS
GUAM
HAWAII

▨ **STATES WHICH HAVE INSURANCE OPTIONS** — ALABAMA ALASKA ARIZONA CALIFORNIA COLORADO FLORIDA GEORGIA HAWAII IDAHO ILLINOIS INDIANA IOWA KANSAS KENTUCKY LOUISIANA MARYLAND MASSACHUSETTS MINNESOTA MISSOURI NEVADA NEW JERSEY NEW MEXICO NEW YORK NORTH CAROLINA OHIO OKLAHOMA OREGON PENNSYLVANIA PUERTO RICO RHODE ISLAND TENNESSEE TEXAS UTAH VIRGINIA WASHINGTON WEST VIRGINIA WISCONSIN

☐ **MANDATORY NCUSIF INSURANCE** — ARKANSAS CONNECTICUT MAINE MICHIGAN MISSISSIPPI MONTANA NEBRASKA NEW HAMPSHIRE NORTH DAKOTA SOUTH CAROLINA VERMONT

■ **NO STATE CREDIT UNIONS**— DELAWARE D.C. GUAM SOUTH DAKOTA VIRGIN ISLANDS WYOMING

The Chairman's Review

The events of the past twelve months have highlighted the uniqueness of credit unions and their insurance system more than any of us could have ever anticipated. For the 14 members of the International Share and Deposit Guaranty Association and their 3,100 credit unions the momentum has changed dramatically.

Throughout 1984 the cooperative credit union insurers continued a two and one-half year expansion effort that saw over $1.1 billion of state chartered credit union savings switch from federal to private funds. Partly in response to this pressure and partly due to concern that the public would perceive the NCUA Share Insurance Fund (NCUSIF) as the weakest of all federal insurers, NCUA introduced legislation that copied the financial structure of the private funds. This effort, which quadrupled the capital base of the NCUSIF, was completed in January of 1985 with predictions of a possible dividend. This event by itself would have created a very different competitive relationship than had recently existed with NCUA. Then the crises in Ohio and Maryland among state chartered savings and loan insurance corporations added a new external threat and a media promoted anxiety concerning the credibility of any private insurance fund.

One result has been a swing of the pendulum back in the direction of federal insurance. However, another concern has been the issue raised not just by external commentators, but by some in the credit union community as to whether the movement should even worry about these swings—in effect asking if private insurance still provides a benefit for credit unions and their members. We believe the articles in this *Yearbook* will answer this question by showing the historical, philosophical and real "bottom line" advantages of private insurance. Not only was credit union insurance first offered by a private fund in 1961, but also almost all of the major credit union innovations in field of membership, delivery of services, new product introduction, investment options, and many other areas of operation have been developed in the state chartered, privately insured system. These ideas, once tested and found workable on a local level, then spread across the credit union community to be accepted as the norm. The most dramatic example of this leadership is share deregulation which was tried, accepted, and succeeding in more than a dozen states prior to comparable action by NCUA in 1982 for federal credit unions.

Credit unions' uniqueness has been their ability to change in response to the needs of their members in the many different markets throughout the country from the community based credit unions of New England, to the industrial and occupational groups of the midwest, to the high tech companies in California and the senior citizen and retiree communities of the sunbelt states. The result has been a cooperative financial system that is growing faster and is far stronger by almost any measure of analysis than competing financial systems. Private share insurance has been a keystone in this credit union success by providing the only meaningful dual chartering system. This option has fostered innovation and creativity, and has given the checks and balances that prevent one regulatory institution's view—whether state or federal—from being imposed on a rapidly changing marketplace.

And the economic advantage of private insurance, as discussed in the following articles, is that credit unions have created not just a more responsive insurance system, but a more ***cost effective*** one through the combined efforts of the IS&DGA members.

There is no question however that the challenges of the present are greater than any of the recent past. Standing on our record or on our philosophy is not enough to meet our commitments to the continuing success of credit unions. IS&DGA, created in 1979, is vitalizing its organization. In May the Board voted to hire the newly formed credit union consulting firm of Callahan & Associates to coordinate these efforts. Senior partner Edgar F. Callahan is the former state regulator in Illinois and from 1981 to 1985 was the NCUA Board Chairman. In the interview that begins on page 10, Mr. Callahan reaffirms the historical contributions and continuing advantages of private insurance.

But IS&DGA members are doing more than promotion. We are continuing to refine our insurance tools to help credit union managers better compete in a deregulated marketplace. Our goal for the next year is to bring a new level of insurance protection and assistance so that private insurance continues to be at the leading edge of credit union successes. We are excited by the opportunities on our horizon and hope this *Yearbook* will be just the first chapter in a new era of unique accomplishments.

John Martin
Chairman, IS&DGA
July 22, 1985

CONTENTS

INSURANCE OPTION MAP 1

CHAIRMAN'S REVIEW 2

PRIVATE INSURANCE: THE CREDIT UNION ADVANTAGE 3
by Catherine England

PRIVATE CREDIT UNION SHARE INSURERS INNOVATION AND RESULTS 6
by Bert Ely

SHARE INSURANCE QUESTIONS AND ANSWERS
with Edgar F. Callahan, Former Chairman, National Credit Union Administration 10

CALLAHAN AND ASSOCIATES 14

INTERNATIONAL SHARE & DEPOSIT GUARANTY ASSOCIATION DIRECTORY 15

INTERNATIONAL SHARE & DEPOSIT GUARANTY ASSOCIATION

CALLAHAN AND ASSOCIATES
4853 CORDELL AVENUE, SUITE 8
BETHESDA, MARYLAND 20814

For General Information and Press Inquiries
(301) 656-8890

For Information on a Specific Corporation
(See pages 15-16)

PRIVATE INSURANCE: THE CREDIT UNION ADVANTAGE

by Catherine England

Catherine England is a senior economic policy analyst with the Cato Institute, based in Washington, D.C., where she is also assistant editor of the Cato Journal. Miss England has an M.S. in economics from Texas A & M University, and expects to receive her Ph.D. from there later this year. She has written extensively in the area of banking regulation and deposit insurance, including recently published articles in the Wall Street Journal and Consumers' Research Magazine. She is also the author of Banking and Monetary Reform, recently published by The Heritage Foundation.

No one could have foreseen when 1985 began the events that would direct public attention to private deposit insurers and the institutions they serve. In March, the savings and loan crisis in Ohio was widely portrayed as a "failure of private deposit insurance," and even though no credit unions were insured by the Ohio Deposit Guarantee Fund, depositors suddenly became more aware of those signs in the window advertising the source of share guarantees. As if that were not enough, the Ohio crisis was followed in May by the S&L episode in Maryland. While less dramatic, the problems encountered by the Maryland Savings Share Insurance Corporation intensified the interest in non-federal deposit insurance. Local television stations sent news crews out to unearth privately insured institutions, and consumers' advocates urged individuals to consider carefully before putting their hard earned money into non-federally insured institutions of any kind.

Politicians have also, predictably, joined the bandwagon to call for mandatory universal federal insurance. Several state legislators and their governors, eager to avoid even the hint of problems similar to those in Ohio and Maryland, are considering requirements that would force all deposit-taking institutions to obtain federal insurance. State banking supervisors in some states are making public their preference for federal guarantees, even though no legal directive exists, thus attempting to use private and public pressure to encourage privately insured credit unions and savings and loans to apply for federal coverage. And in Washington, several bills have been introduced in Congress that would compel all depositories to obtain their insurance from one of the three federal funds.

It seems to be rapidly becoming the conventional wisdom to support federal insurance. "Why should depositors risk their savings in privately insured institutions if federal guarantees are available and comparably priced?" experts ask. And many depositors may wonder the same thing. As Jim Blaine, president of the North Carolina State Employees Credit Union, a privately insured institution that recently applied for federal insurance when its private guarantor elected to dissolve, pointed out in a recent interview, "The federal system allows the depositor to be lazy. The public perception is that 'federal' is safer."

MORE THAN CHOOSING CAR INSURANCE

But the choice involved is not as simple and straightforward as, say, choosing or changing car insurance. The issue at hand is much more far reaching and, ultimately, raises fundamental questions about who will make long-run decisions about the future directions of the credit union movement and the role it will play in tomorrow's economy. Credit unions and their members, in deciding whether to fight to maintain the current dual system of share insurance or to acquiesce to political pressures calling for a federal monopoly, are really deciding whether regulatory control of the industry will remain largely decentralized with the states continuing to play important roles or the National Credit Union Administration will be allowed to take the dominant part in regulating credit union activity.

"The insurer is a regulator. With a monopoly insurer, dual chartering becomes a sham."

While often lumped with other depository institutions in texts and news stories, the nation's credit unions have a very different history. As Robert A. Sorin, Ohio Superintendent of Consumer Finance, noted in a recent interview, "My opinion, and that is after having worked through hundreds of financial statements, is that credit unions are inherently different from savings and loans."

Their cooperative nature and emphasis on people, not profit, have always set these institutions apart from other depositories. Members tend to know each other because they often work together or live in the same community. Hence, from 1909, when the first credit union was established, until 1961, when the Massachusetts Credit Union Share Insurance Corporation was founded, credit unions not only managed to attract and hold funds without any deposit insurance, they thrived. And it was not until 1970, more than 35 years after the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) were established, that Congress made federal insurance available to credit unions.

Currently, there are 14 private insurance funds offering deposit guarantees to credit unions in 25 states and Puerto Rico, and the credit union industry has avoided shocks similar to those experienced of late by the thrift industry. Thus, credit unions are set apart not only by the nature of their business but also by the fact that they have almost a quarter century's experience with a private share insurance system that has worked.

PRIVATE INSURANCE PREDATES FEDERAL

In fact, it was at least in part the development of private guarantors that led Congress to "reward" the credit union industry with a federal insurer of its own. The National Credit Union Share Insurance Fund (NCUSIF) was established in 1970, making it by far the youngest of the federal insurance funds. And, because it was never loaned capital by the federal government as were the FDIC and FSLIC, the NCUSIF in the early 1980's found itself the weakest of the three federal funds. To strengthen its reserves, the NCUSIF recently changed its whole approach to building the fund's capital base. And what was the model used for revitalizing the NCUSIF? Rather than looking to the other federal insurers, National Credit Union Administration officials turned to private share insurers to discover what had worked in the credit union industry.

Because private insurance historically has played a much larger role in the credit union industry than for savings and loans—insuring 18% of all credit union savings—the advantages of such a system are more obvious among credit unions than among other depositories.

Chief among these advantages is the diversity that marks the credit union industry. Among credit unions there remains a truly dual system of chartering, and that choice is a direct result of the widespread existence of private share guarantees for credit unions.

INSURER IS A REGULATOR

As Ed Callahan, Chairman of the National Credit Union Administration until May 1985 and now a senior partner of Callahan and Associates, has pointed out, "The insurer is a regulator. The credit union system is working well today because there is a balance between state and federal insurers and regulators. Credit unions have a viable option. With a monopoly insurer, dual chartering becomes a sham." While minor distinctions may exist between state and national bank charters, for example, all important regulatory decisions for banks are made in Washington. Congress and the federal regulators justify their control over all banks by noting the role the federal government plays in guaranteeing almost all bank deposits.

"Unforeseen events could turn federal regulations into a hangman's noose."

But what's wrong with the central control of an industry? Why should credit union managers and members be wary of federally mandated homogeneity?

First, no one can foresee how changing economic and technological conditions will affect the markets and competitive status of credit unions. Thus, the ultimate keys to survival require an ability to adapt to changing conditions and to diversify one's earning assets.

State legislators and regulators are generally faster to adapt to rapidly changing conditions by removing or modifying excessively binding regulations than their federal counterparts. As Gene Artemenko, president of United Airlines Credit Union, recently noted, "Statutory changes, regardless of how well justified, are much more difficult to enact at the federal level because there are 435 Representatives and 100 Senators deciding whether a particular law should be changed, and the American Bankers Association, the savings and loans, as well as others all get into the act and try to control what happens to you." With private share insurance and state regulation, Artemenko says, "We find there is much more flexibility because we're much closer to the regulators."

"You can't have logic when you're dealing with 18,000 credit unions."

DIVERSITY PROTECTS THE INDUSTRY

In addition, extensive federal control of any industry carries with it serious risks if subsequent events prove a particular regulatory decision wrong. For example, a large part of the thrift industry's problems can be explained by federal policies requiring all S&Ls to invest the lion's share of their assets in long-term, low interest, fixed-rate home mortgages. Neither individual institutions nor the industry was able to diversify and, as a result, the industry (and, hence, its federal insurance fund) is in dire straits. Similarly, if virtually all credit unions become subject to federal regulation, the entire industry will be affected if unforeseen technological or economic events turn federal regulations designed as a safety net into a hangman's noose. Diversity among regulators, therefore, is a means of protecting the industry.

Beyond these "safety and soundness" and "good of the industry" arguments for maintaining a dual system of regulation and insurance, there are significant advantages to individual credit unions—whether federally or privately insured and regulated.

Gene Artemenko, in explaining why his credit union is committed to the idea of private guarantees, notes that, "If you do what everyone else does, 'ordinary' becomes the standard."

FEDS SAY "NO" TO NOW ACCOUNTS

Robert F. Bianchini, President of the Rhode Island Credit Union League, cites federal inflexibility as the very reason Rhode Island has a private share insurer. The Rhode Island Share and Deposit Indemnity Corporation was established because the National Credit Union Administration refused to provide federal insurance to Rhode Island-chartered institutions providing checking accounts to their members. Rhode Island regulators, foreshadowing future trends in the financial services sector, had okayed checking accounts for credit unions while federal regulators had not yet recognized which direction the market would take. Bianchini notes that Rhode Island credit unions have since had reason to "thank our lucky stars that incident took place and a private insurance fund was formed."

Marvin Umholtz, Vice President of the Kansas Credit Union League adds, "I think local control is one reason why members opted for the right to use either [federal or state] insurance, maybe they think the Kansas legislators will be more understanding of their problems than the Congress."

Additionally, Bianchini points out that federal authorities

■

cannot always react with the same sensitivity as a private insurer. He cites examples of several strong credit unions operating in Rhode Island today that would not be around if it were not for private insurance. At various points in their history, these credit unions ran into serious problems, but, Bianchini notes, "The personal attention, the local presence of the Rhode Island share insurer, was paramount to providing solutions to those problems. Federal insurers would have been unable to deal with problems on as personal a basis because of the sheer numbers with which they have to deal. These institutions would have been simply merged or liquidated rather than being nursed back to health."

"Private insurers can facilitate deregulation."

The private system benefits federal credit unions as well. For instance, it allows Art DeRusso, President of the Eastern Airlines Federal Credit Union, to offer his members insurance on every dime of their deposits, including those exceeding $100,000, by using private insurance as a supplement to his federal guarantees. Similar options are largely unavailable to other depositories, and without an active system of private insurance, funds would be unavailable to credit union members. Federal law prohibits any federal insurance fund from offering insurance that exceeds $100,000 unless the two other funds also expand their coverage.

CHOICE BENEFITS CONSUMERS

Federal and state officials agree it's good to have a choice. JoAnn Ewalt, a spokeswoman for the NCUA, responded in a recent interview: "We [the NCUA] do not favor mandating federal insurance. We think people should be encouraged that there are privately insured credit unions."

And Bob Bianchini adds, "Without a viable alternative system of insurance, there is no place for an institution to turn if its members believe a new service or program is warranted even though it is not authorized under federal standards. These standards may have nothing to do with the safety and soundness of a particular institution. A dual insurance system provides for competition within regulation, and in the long run, it is the consumer who benefits from that competition."

In spite of the clear advantages of a dual system of supervision and insurance, private insurers and their insured institutions are taking a hard look to identify and correct any weaknesses in the system. Through a revitalized IS&DGA, the funds are cooperatively studying issues such as: Does each fund have the ability to detect and the power to deal with problems as they develop? Are there contingency plans to deal with major failures? Has each fund adequately diversified its risks?

As noted by Tom Gaines, President of the State Credit Union Share Insurance Corporation based in Tennessee, "Private insurers can facilitate deregulation by credit unions by constantly changing their bag of tools to deal with the new products and services consumers are demanding." Private insurance has given all credit unions a critical advantage in servicing their members.

"We (NCUA) do not favor mandating federal insurance. We think people should be encouraged that there are privately insured credit unions."

THE ADVANTAGE WORKS

And the member has benefited, as the record dramatically indicates. For the last 3½ years, credit unions have had one of the most remarkable recoveries of any sector of the economy. In the recession of 1981-82, they were the most vulnerable of all financial organizations because of problems at sponsoring organizations, such as layoffs and plant and military base closings. But credit unions rebounded with vigor.

Share growth at annual rates of almost 20% is more than twice that of their nearest competitor, earnings are up substantially, reserve levels have risen, and membership expansion continues. Moreover, all of the negative signs—liquidations, number of problem credit unions, insurance expenses—are down.

These results are even more outstanding in the face of deregulation, with its new competitive pressures and players. But were these results inevitable? Hardly. Newspapers and television report daily about worsening figures in banking and S&L industries—depression level numbers of failures, record losses, and constant Congressional hearings. Clearly, the success of credit unions is not because "a rising tide (of economic recovery) lifts all boats."

"Diversity among regulators is a means of protecting the industry."

Rather, their success is due to the organizational systems and commitments credit unions have made to their members and to each other. Cooperative share insurance is a vital part of this system. The private funds are pioneers in both the concept and the practice of share insurance. They were both stimulus and example for the NCUSIF's restructuring and they continue to be innovators today. While many factors have contributed to credit union successes, the ever increasing public interest in share insurance has made creative private insurers more vital than ever before. One only has to look at the media headlines, the pessimistic forecasts, and the controversies surrounding the FSLIC's and the FDIC's efforts to adapt to a new environment to realize how fortunate the credit union movement is. Without the energizing force of private insurance, credit unions and the NCUSIF could just as easily still be a part of the economic and political issues affecting those industries.

Private Credit Union Share Insurers - Innovation and Results

by Bert Ely

INNOVATION

Private credit union share insurers have led the way for 24 years in protecting credit union share balances. Since 1970, these agents of change have also represented an important alternative to federal share insurance. This alternative is also key to preserving dual chartering for the credit union movement.

Today, these private insurers, the 14 U.S. members of the International Share and deposit Guarantee Association (IS&DGA), protect 10 million members in over 3,100 state-chartered credit unions. Today, they continue the innovative tradition first established in 1961 by the Massachusetts Credit Union Share Insurance Corporation.

IS&DGA members led the credit union movement towards share insurance. Now over 99% of all credit unions are insured. IS&DGA members have led in developing sound funding methods for credit union insurers. They have led in developing the techniques that minimize losses in failed credit unions. They have been the proving ground for many innovations later adopted by the National Credit Union Share Insurance Fund (NCUSIF). Operating under the vigilance of their boards of directors and their state credit union supervisors, these innovative insurers will continue to lead the way.

An examination of these innovations, and the advantages they offer to the credit union movement, is in order.

One key strength of any insurer is the adequacy of its reserves. Without adequate reserves, the insurer's promise to pay is a hollow phrase. Private share insurers, recognizing very early the slow process of accumulating adequate reserves from retained earnings, innovated. Every insurer adopted, in one form or another, the deposit method for quickly building an adequate reserve, and for growing those reserves as insured shares grew. Deposits usually equal ½ of 1% to 1% of the savings in each credit union. As each credit union's total savings changes, its deposit with its insurer is adjusted at least annually. Today, some share insurers have even built their reserves to the point that investment earnings are sufficient to maintain an adequate reserves/shares ratio.

NCUSIF COPIES PRIVATE FUNDS

The NCUSIF, long plagued by inadequate reserves, adopted its 1% deposit program only last year. Federally insured credit unions quickly agreed to the 1% deposit plan, in large measure because private share insurers had already pioneered and refined the deposit concept. Now all credit unions have far stronger reserves protecting their shares than are available to protect deposits in banks and savings and loans. The NCUSIF deposit plan is just one example of the innovative competition between the NCUSIF and its private counterparts that has benefited all credit unions since the federal insurer was founded in 1970.

The NCUSIF has also adapted many of the loss control methods previously developed and refined by the private insurers. Closely monitoring every credit union is key to minimizing insolvency losses in those few that fail. All private insurers have well-established monitoring mechanisms based on monthly or quarterly financial reviews, close working relationships with state regulators, and visits to those credit unions showing signs of financial distress. Some of these monitoring systems have even been computerized so that adverse trends in individual credit unions can be quickly spotted.

In this age of deregulation and greater diversity among credit unions, the key to successful supervision of insured credit unions is closeness—physical and psychological—and flexibility rather than uniform rules and infrequent examinations. The ongoing supervisory interplay between private share insurer and credit union permits the insurer to stay close to the credit union marketplace and thus adapt more rapidly to it than can a federal insurer in distant Washington. Even as the NCUSIF adapts techniques first developed by private insurers, IS&DGA members, each supervising just a few hundred credit unions, stay closer to their insureds than can the NCUSIF to its 15,000 insureds.

INSURANCE FOSTERS FLEXIBILITY

Private share insurance has been especially beneficial to credit union members in the twenty-five states plus Puerto Rico that permit private share insurance. In these states, state-chartered credit unions operate with a regulatory flexibility and forward thinking that is just not feasible for federally insured credit unions, much as the NCUA has tried to be flexible. Consequently, privately protected credit unions can offer a broader range of services to their members and thus maintain their competitive edge with banks and S&Ls.

Innovation continues to evolve among IS&DGA members. For example, two insurers already operate in several states, and others may join them to regionalize private share insurance. Half of the IS&DGA members now offer insurance limits higher than NCUSIF's Congressionally restricted limit of $100,000. Several even insure entire account balances. One member also offers excess insurance to federally insured credit unions so that these credit unions can protect account balances higher than $100,000. Almost every IS&DGA member now undergoes an annual outside audit by a qualified CPA firm.

IS&DGA members have also developed various techniques for legitimately minimizing their federal corporate income tax liabilities even as they continue to oppose the recent imposition of this tax. In what is decidedly a double standard, the NCUSIF is exempt from all taxes.

RESULTS

Share insurance is like any other economic activity—the results are what really count. And the results have been impressive. As Chart A shows, total savings in credit unions insured by IS&DGA members have more than doubled over the last five years, growing 138% to $17 6 billion.

TOTAL SAVINGS IN CREDIT UNIONS INSURED BY IS&DGA MEMBERS

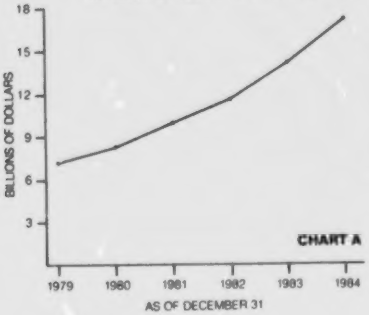


CHART A

This share growth reflects not only the continuing popularity of credit unions, but also the increasing role IS&DGA members play as insurers of state-chartered credit unions. As Chart B shows, both the percentage of state credit unions insured by IS&DGA members as well as the percentage of savings in IS&DGA-insured credit unions have increased since the IS&DGA was founded in December 1979.

IS&DGA MARKET SHARE GROWTH

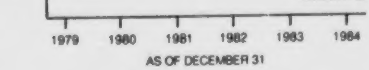


CHART B

In fact, as shown in Chart C, shares in credit unions insured by IS&DGA members have grown at a faster rate since 1981 than they have in federally insured state credit unions!

RELATIVE GROWTH IN INSURED SAVINGS: IS&DGA INSURED CUs VERSUS NCUSIF-INSURED CUs

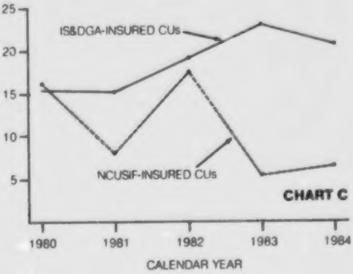


CHART C

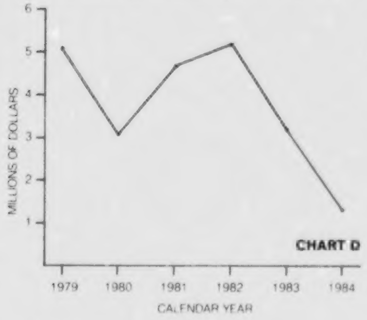
LOSSES DOWN DRAMATICALLY

More important than growth, however, is the quality of protection private share insurance offers. And here private insurers have excelled by closely monitoring their insureds. Through continually improving monitoring processes, IS&DGA members have trimmed their net insurance losses by almost three-fourths since these losses peaked in 1982. Chart D dramatically illustrates this most favorable trend.

This improvement is particularly impressive in light of the fact that the American economy dipped more sharply in 1982 than it did in 1980. The 1980 decline in real GNP, coupled with the extensive banking deregulation taking place at that time, triggered the relatively high insurance losses of 1981 and 1982. That credit union insurers have done so well since the 1982 recession confirms two facts: State-chartered credit unions have put the worst of the impact of banking deregulation behind them and private share insurers are better equipped than ever to minimize credit union failures, and losses in those few that fail. Both of these facts bode well for the future of private share insurance, and the preservation of dual-chartering for credit unions.

The loss record for IS&DGA members becomes even more impressive when compared to NCUSIF's record. Chart E illustrates this performance by contrasting comparative loss experiences in terms of losses per insured share dollar. Since 1980, NCUSIF's losses have significantly exceeded the combined loss experience percentage of all ISDGA members. The greatest disparity in performance occurred in 1982 when NCUSIF's losses zoomed to 13.6 basis points per insured share dolar while IS&DGA losses declined to 4.6 basis points. One basis point equals .01%. Even as NCUSIF's loss rate has dropped substantially from its 1982 peak, the loss experience of IS&DGA members has fallen even more dramatically.

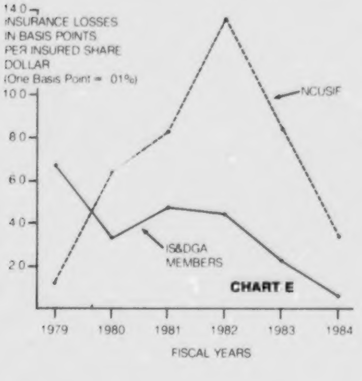
NET CLAIMS PAID BY IS&DGA MEMBERS



CLOSE SUPERVISION BY FUNDS

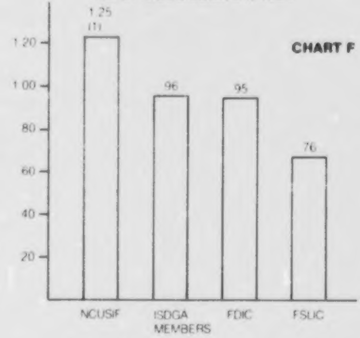
The payoff from close monitoring is seen from another perspective by comparing the accompanying consolidated income statement for IS&DGA members with NCUSIF figures. During 1984, IS&DGA members on average spent more than three dollars in monitoring and administrative costs for every dollar of net insurance losses and reinsurance costs they incurred. IS&DGA members have clearly spent this money wisely to save credit unions and prevent losses. NCUSIF's experience is almost the opposite. In 1984, its insurance losses were almost triple its administrative and monitoring expenses. That's why NCUSIF's 1984 loss rate was four and one-half times higher than the combined loss rate for IS&DGA members.

COMPARATIVE INSURANCE LOSS EXPERIENCE—NCUSIF COMPARED TO IS&DGA MEMBERS



Share insurer reserves continue to be the bulwark protecting credit union members. Here IS&DGA members excel. While NCUSIF reserves as a percentage of total shares now exceed the combined reserves/shares percentage for IS&DGA members, as shown in Chart F, the IS&DGA members' ratio is still comparable with the FDIC ratio and comfortably above FSLIC's ratio.

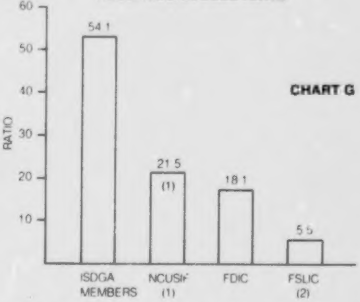
INSURANCE RESERVES AS A PERCENT OF TOTAL SALES/DEPOSITS AS OF DECEMBER 31, 1984



(1) INCLUDES 1% DEPOSIT ASSESSED BY NCUSIF AS OF 12-31-84

The ratio of reserves to recent losses, however, is a much better measure of reserve adequacy. As Chart G shows, IS&DGA members demonstrate two and one-half times as much strength here as does the NCUSIF.

RESERVES/LOSSES RATIO



RATIO OF INSURANCE RESERVES AT FISCAL YEAR-END 1984 TO AVERAGE INSOLVENCY LOSSES FOR THE 1982-1984 PERIOD

(1) Includes the 1% deposit due as of 12-31-84
(2) Based in part on estimate for FSLIC's 1984 insolvency losses

CONSOLIDATED FINANCIAL STATEMENTS OF THE FOURTEEN PRIVATE U.S. CREDIT UNION INSURERS

(unaudited)
(dollars in thousands)

BALANCE SHEET

As of fiscal years ending nearest to December 31, 1984

Assets	
Cash and investments	$184,117
Deposits, assessments receivable from member credit unions	7,549
Interest and dividends receivable	2,615
Other current assets	545
Advances to, assets acquired from member credit unions	4,495
Office furniture and equipment, net of depreciation	1,103
Other non-current assets	521
Total assets	$200,945
Liabilities and Members' Equity	
Accounts payable	$ 718
Deferred revenues	1,100
Reserves for losses	15,203
Loans and other indebtedness	3,298
Income taxes payable	438
Other liabilities	1,209
Total liabilities	21,966
Members' equity:	
Refundable deposits	103,201
Retained earnings and other capital	75,778
Total members' equity	178,979
Total liabilities and equity	$200,945

INCOME STATEMENT

For the fiscal years ending nearest to December 31, 1984

Revenues	
Member assessments	$ 6,308
Interest on investments	17,392
Other	2,034
Total revenues	25,734
Expenses	
Operating and administrative	6,222
Net losses and reinsurance expense	1,766
Interest and line-of-credit fees	406
Total expenses	8,394
Pre-tax income	17,340
Income taxes	300
After-tax income	$ 17,040

The credit union movement can take great comfort in the fact that both of the insurance options—federal and private—available to credit unions show greater financial strength than the federal monopoly insurers for banks and savings and loans. The relatively greater strength of the NCUSIF, when compared to the other two federal deposit insurers, highlights the fruits borne by competition among credit union insurers.

The accompanying consolidated balance sheet for the fourteen members of the IS&DGA shows that collectively they had $201 million of assets and members' equity of $179 million. While NCUSIF's fund balance far exceeds $179 million, NCUSIF would need another $1.75 *billion* in members' deposits and retained earnings to achieve the same reserves/loss ratio IS&DGA members have already accumulated.

Bert Ely is a Corporate Financial Consultant located in Alexandria, Virginia. He holds a BBA from Case Western Reserve University and a MBA from the Harvard Business School. Mr. Ely has focused his consulting activities on assisting financially troubled corporations and conducting deposit insurance studies. He has written several articles and papers and spoken on numerous occasions on the subject of deposit insurance reform.

SHARE INSURANCE QUESTIONS AND ANSWERS

Edgar F. Callahan, former Illinois regulator and NCUA Chairman, responds to the most frequently asked questions that have been raised about private share insurance.

Q. Mr. Callahan, in the wake of the crises in the savings and loan private insurance systems in Ohio and Maryland, why do you think private credit union share insurance can succeed?

A. I think private credit union insurance will not only succeed, but I also believe it will be one of the key factors in credit unions' future success. The crises in Maryland and Ohio were savings and loan problems, not credit union problems, or even an insurance problem. All savings and loan insurers, even the Federal Savings and Loan Insurance Corporation, are suffering from the very severe problems of that industry.

More importantly the private credit union funds are part of a credit union financial system that repeatedly has demonstrated its ability to plan for change so that the financial mechanisms are in place to respond to any emergency or threats.

Moreover, credit unions are unique in this cooperative system of assistance and in their close member relationships. In the event of a crisis of confidence credit unions have repeatedly shown that they are willing to work together in ways the other financial systems cannot.

Q. But how would a private fund stop a run—isn't that the real reason *federal* insurance works better?

A. No. The public seems to have a very short memory. The recent phenomenon of runs started at federally insured institutions—Continental Bank in Chicago and Financial Corporation of America (FCA) in California. In both instances the federal insurance fund did not put up the liquidity. The Federal Reserve system, along with a consortium of banks, bailed out Continental, and the Federal Home Loan Bank system supported FCA. No insurer by itself has the liquidity to stop a run at its largest institutions without the support of the financial system.

And credit unions insurers have that system in place, and have had it in place for years. The corporate credit union network, with U.S. Central at the hub, provides liquidity from throughout the country to meet whatever temporary shortfalls may occur. That pool of funds now exceeds $11 billion. U.S. Central in turn can tap the private market for funds. Backstopping this is the Central Liquidity Facility (CLF) to which virtually all credit unions belong due to the joint membership application of the corporate central network. Private share insurers by law have the right to borrow from the CLF which in turns funds its loans through the Federal Financing Bank, a part of the U.S. Treasury.

Credit unions have the same ultimate liquidity lender, the Federal Reserve, as do all banks and S&Ls. And *in addition*, all credit unions have a complete second system resting ultimately on the CLF. In the final analysis a privately insured credit union has more liquidity options than a federally insured bank or S&L.

Q. Even if this is true, doesn't the public prefer "federal" insurance? Isn't that really the ultimate test of safety and soundness?

A. If the answer to that were yes, then the strongest bank in the U.S. today should be Continental, which is not only federally insured but owned, in a practical sense, by the FDIC. Instead the marketplace still rates Continental at the lower end of the quality scale.

What the public wants, whether this be an individual consumer or the "invisible" forces of the marketplace, is confidence in the integrity and stability of the institution with which they do business.

For example, I was in Rhode Island several weeks ago when the local press had just published that Consumer Credit Bank was phasing out its consumer deposit program in several states to be replaced by wholesale funding sources such as commercial paper. This was a business decision based on the relative costs of different funding sources. However, because of a lack of communication, the local press portrayed this as a concern about private insurance since deposits were insured by Rhode Island Share & Deposit Indemnity Corporation. A three day barrage of front page stories began that caused people to line up outside the Commercial Credit Bank offices in scenes similar to those in Ohio and Maryland.

During that evening we visited a nearby credit union Board and asked what kind of a day they were having. We learned that for the first two days of this "run" about $500,000 had moved from the bank to this credit union, which was also insured by RISDIC. These credit union members trusted the credit union, knew about its community base and support, and had no problem putting their funds there.

Q. But haven't there been instances of runs on privately insured credit unions?

A. Absolutely not. We have yet to find one case of a net deposit outflow from any privately insured credit union in the country before—or after—events in Ohio, Maryland and Rhode Island. In fact the only credit union "run" I'm aware of was at an NCUA insured credit union in the midwest—and again the issue wasn't insurance per se but the perception of problems in the institution.

Q. But how would a manager of a privately insured credit union compete against advertising that tells people to place their savings in a federally insured institution? Isn't the implication that federal is better or safer?

A. That is certainly the message some would like to leave, I'm sure. In fact some of those types of ads are running right now in California. And in the face of this kind of effort, one of the largest privately insured credit unions in the heart of this market has grown over 10%, or $40 million, in just the first six months of this year.

In fact, I think the more an institution, be it an S&L, credit union, or bank begins to tell people that they should do business with them because they are federally insured—that that's the main message—the more consumers are going to start asking what's wrong. Why isn't the bank or S&L telling us about its services or rates or conveniences. Fear does motivate some people some of the time, but after a while people also start to suspect that they are being manipulated and that the real concern these institutions have is with ***their own*** safety and soundness—but they'd prefer others didn't focus on that.

Q. Haven't there been a lot of conversions from state to NCUA insurance by credit unions? Doesn't this indicate that managers or Boards or members want the "perception of safety" brought by NCUA?

A. No, there have not been a lot of voluntary conversions. There have been two states where credit unions were not given a choice but told in one case by the insurer (North Carolina) and in another by the Governor's office (Wisconsin) that private insurance was being phased out. Credit union Boards and managers were not given a choice. I think those were "knee jerk" reactions to the media stories about events in Ohio and that the history, benefits, and credible nature of credit union private insurance were not understood.

To date, the truly voluntary switches to federal insurance have been far fewer in number and much less in dollars than the change to private insurance prior to the beginning of this year. And in fact, and this has been ignored by many, even after the public discussion of the S&L events in Ohio and Maryland, there have been a half dozen conversions to private insurance from NCUA.

Q. But aren't some regulators, as in Massachusetts, telling credit unions to go federal without formal law changes?

A. Yes, the bank commissioner in Massachusetts is very public in his opinion. He thinks all financial institutions in his state should be federally insured and he believes that insurer should be the FDIC. In fact I suspect he is comfortable with the thought that all financial institutions should be banks. But I think his point of view is an exception.

One of IS&DGA's goals is to work more closely with state regulators, administrators and legislators to help them understand how private credit union insurance has made credit unions in their states responsive to their needs. Private insurance preserves the supervision priority of the state. You have yet to read about a private insurance corporation pre-empting state law, but this has happened on numerous occasions at the federal insurance level.

The dual chartering system really only works if there is a dual insurance system. Credit unions' incredible growth has been, in my judgment, due to the flexibility and responsiveness provided by having the only meaningful dual chartering system in this country. To continue these successes in the future will depend no less, in my judgment, on a strengthening of this system.

Q. But the bottom line is, can it work? What can private insurance offer that NCUA cannot?

A. Cooperative credit insurance does work. Not one cent of savings has ever been lost by a member in an account insured by IS&DGA Corporation. Private insurers have been meeting credit union needs for almost twice as long as NCUA insurance. So the results are there, and the funds have grown and prospered.

One critical aspect for continuing success is the ability to control losses. And in this area, the expense history of private insurance is many times better than NCUA's. Look at the situation in Wisconsin. The Wisconsin Credit Union Savings Insurance Corporation, which insures almost $2.3 billion in savings, has had only $1.2 million of insurance losses in its 15 years of operation. That loss ratio per year is virtually nil and is a real tribute to the effectiveness of a local insurer.

But that situation highlights that there also has to be a ***will*** for private insurance to continue—will on the part of managers, boards, regulators and legislators, or even the best track record in the world cannot turn the tide.

Private insurers have credit unions managers on their boards, and they can act quickly to help with problems or to modify programs. They can talk with Leagues, with state regulators and credit unions as ***peers*** about local conditions and local needs. I firmly believe that if the will of the credit union community and the state regulatory system to support private insurance is maintained, then at this time next year you'll see a dynamic, responsive and innovative system of private insurers. The incentives are there and the opportunity is there to take IS&DGA members to new levels of creativity.

Q. How is IS&DGA going to help these funds?

A. First of all, IS&DGA is an integral part of the system. The private insurers will have to continue to innovate to be competitive with NCUA. There are several areas where this now occurs in the extent and amount of coverages and in flexible pricing and rebate formulas. While the press discusses savings insurance almost solely in terms of timely payouts or in an assisted merger context, that represents a very small portion of insurance activity. For the 99% or more of institutions that will not be liquidated or merged involuntarily, insurance effectiveness is a matter of responsive supervision, state-of-the-art tools of analysis, assistance to management in the credit union, and meaningful two-way communication about changes and needs in the marketplace.

Q. But, if you were the manager of a privately insured credit union what would you tell depositors who asked why they should put their funds with you?

A. I think that depositors first want to know that their financial needs will be met by a responsive, well-managed institution. If a credit union isn't doing that, insurance will not cause the member to put in more money. Most money leaves a credit union *not* in response to an insurance worry, but when the credit union can't meet market rates of savings. Remember the largest flow of funds out of the ***federally insured*** system was to the uninsured money market mutual funds before deregulation. This flow amounted to over $200 billion dollars. Insurance per se will not attract or keep a member if the institution is not performing its primary business purposes in a credible way.

For example, service and products that are responsive to local needs and markets are the hallmarks of privately insured institutions. They pioneered deregulation of shares and savings before federally insured institutions. As a result savers received a higher rate of return on accounts tailored for local conditions, not account terms mandated on a nationwide basis by regulatory fiat.

If the members still insisted that they would only be satisfied with federal insurance, then I would point out that their largest asset, their home equity, is not federally insured, that their most important financial contingency, life insurance, is not federally insured, that the most necessary of modern day conveniences, their auto, is not federally insured, and finally the vast majority of retirement funds, the future "nest egg" that we all build for, is probably not federally insured. Federal insurance is not the answer to deep seated concerns about safety in any area of our life or commerce. And it's a myth that this needs to be the situation for savings insurance.

Q. You'd get an argument on that point from a lot of people. Bill Isaac, FDIC Chairman, was quoted as saying, "There is no excuse for private insurance." and even Ed Gray, FSLIC Chairman, testified that "In my opinion the public would be better protected by requiring federal insurance for all depository institutions."

A. Well, I worked with both men while I was at NCUA. And I think they would probably be the first to admit that they are not familiar with the credit union system and its history of credit union insurance. So, in fact, their statement is more a rhetorical point than a practical one since credit union private insurance does work, predates federal insurance, and, in fact, works so well that we copied the main tenets when we restructured the NCUA fund.

But you also have to bear in mind that there are a host of other messages in those statements. I think it is natural to want a monopoly on any economic activity.

Competition cannot only expose an organization's shortcomings, it can create a much more complex operating environment. Remember the insurer is a regulator. In a dual chartering system with comparable state and federal powers, dual insurance operates as a check and balance on the other regulator. A single federal insurer might make life somewhat less complicated, but I question whether it is in the industry's interest, in the consumer's interest, or in the state's interest. I think the record is clear for credit unions that a dual insurance system works, and works well for everybody.

Q. How does it work well for federally insured credit unions?

A. Private insurance is probably the single most important reason why federally insured credit unions have a responsive federal insurance and regulatory system. Without options there is one system of regulation, of reserving, of investments, of risk evaluation, and one standard of reporting. And while uniformity might work for a time, one has only to look at the crises in the other financial systems to see what happens when an industry has had one uniform approach to a rapidly changing marketplace imposed by laws and regulations.

As I said earlier, almost all of the significant innovations in credit unions have come from the state chartered system.

Q. But how do you answer the national columnist who states that "under normal circumstances private insurance could do the job, but these firms lack the bottomless pockets that may be needed to reassure the public in the event of a major loss?" Or the claim in a credit union brochure that private insurance and federal insurance are distinctly different, but "only one, federal insurance, is backed by the financial strength of the United States Government?"

A. All of the money spent (expensed) in ***all*** private ***and*** federal insurance funds comes from the insured institutions themselves, not the government. This is in the form of premiums or capital. If there is a weakness in a fund, as there has been periodically in every fund, the source of money for losses or new capital for each fund has always been first in the industry. ***Every*** fund, whether private or federal, relies upon external sources of liquidity to meet the most extreme needs. And in all cases, private or federal, the ultimate liquidity source is not the insurance fund but the Federal Reserve System and for credit unions—The U.S. Treasury via the CLF.

In cases where government has had to step in to "bail out" a fund, as occurred in Maryland, Ohio and California, the "bail out" was to dissolve the fund.

To imagine a situation where the general public's tax funds would be used at a state or a federal level to bail out or cover losses in an insurance fund without at the same time radically altering the fund is inconceivable. The state legislature or Congress will demand a tradeoff if public monies are needed to save a specific industry's fund—no matter how vital that industry thinks it may be to the general public. The tradeoff in the past has been the dissolution of the fund and forcing the institutions to go elsewhere for insurance or to liquidate. I think that is what would occur if any credit union insurance fund, even NCUA, ever went outside the credit union system for capital to save the fund.

As for the columnist who said private funds lack "the bottomless pockets" that federal ones do, this person hasn't been living in the real world since the last political cycle. In the face of the budget deficit pressure, I know of no industry, special need, or group that would claim that Washington is a "bottomless pocket" for its rescue. That is both naive and misleading. If an economic disaster that required a massive federal bailout, should ever strike this country I suspect the entire system would become like Continental Bank, government owned and directed.

Q. But isn't size important? How can 14 private funds compete with one major federal fund?

A. NCUA does have certain economies of scale in administering its programs. However, most of the costs of insurance are in the losses suffered in mergers, liquidations, and temporary assistance. NCUA's ability to perform at anywhere close to the result of the private funds in this area of activity has yet to be demonstrated.

In fact, I think this is where the private funds have the major advantage. Because of the structures of their organizations, in which the insurers are represented on the Boards of the funds, I think there is built-in direction and incentive for both management and privately insured credit unions to solve problems as economically as possible.

While we tried to incorporate market-like pressures and disclosures in NCUA's insurance operation, government basically knows how to do one thing to solve problems—spend money.

So while size can help, in the insurance area responsiveness, being close to the situation, and fast action are ultimately much more critical in efficient problem solving than size. And history shows the private funds can compete—that's one reason while I was at NCUA we were forced to look for a better way than second premiums to build fund equity.

Q. Why did you choose to make this effort for IS&DGA one of the first commitments of your firm? Some think you just signed up for a ticket on the Titanic.

A. I think the question of choices and options is critical for credit unions' future. Chip's, Bucky's and my move from government was to become a part of the credit union movement. Without choices the vitality, the creativity, and the responsiveness to member needs that has really made credit unions unique in this country's financial system would be seriously eroded. The members of IS&DGA have been part of this pioneering spirit. We believe that this is a very critical opportunity for credit unions, for the private funds and for us personally. We have supported private insurance since 1977 in Illinois and we think that credit unions will respond and continue to support these insurers if the issues at stake can be clearly presented.

Callahan and Associates

Callahan & Associates is a credit union consulting firm located in the Washington, D.C. suburb of Bethesda. The company was formed in May 1985. The three senior partners, who were most recently the Chairman, the General Counsel, and the Director of the Office of Programs of the National Credit Union Administration (NCUA), bring over 25 years of credit union experience to the new company.

The firm serves credit unions and credit union organizations throughout the United States. Services include expansion studies, financial troubleshooting and turnaround, credit union organization, merger evaluation, strategic planning, expert testimony, education, government affairs consulting and data-based financial analysis and reference listings. To develop management tools for credit unions, the firm has purchased under the Freedom of Information Act the semi-annual financial reports filed by credit unions with NCUA. These data based tools and other self-evaluation products are designed to assist individual credit unions to maximize their opportunities and performance.

In June, Callahan & Associates was chosen to manage the IS&DGA. In addition to joint efforts on behalf of these cooperative credit union insurers, the firm works directly with individual insurers to review and strengthen critical areas of organizational activity.

The professional staff of Callahan & Associates includes:

Edgar F. Callahan served as Chairman of the National Credit Union Administration from 1981 to 1985. This agency is responsible for chartering and supervising over 10,000 federal credit unions and insuring 5,000 state chartered credit unions. Prior to this, Mr. Callahan was Illinois Director of Financial Institutions and from 1975 to 1977 was Illinois Deputy Secretary of State. Mr. Callahan received his Bachelor's and Master's degrees from Marquette University.

Wendell A. ["Bucky"] Sebastien is a lawyer with 15 years' experience in government service. From 1982 to 1985, Mr. Sebastian was General Counsel to the NCUA. From 1977 to 1981 he was the General Counsel and office administrator of the Illinois Department of Financial Institutions. Mr. Sebastian received both his B.S. in Philosophy and his Juris Doctorate from Loyola University in Chicago and in 1981 completed the program for Senior Managers in Government from the John F. Kennedy School of Government at Harvard University.

Charles W. ["Chip"] Filson from 1981 to 1985 was President of the Central Liquidity Facility of NCUA and Director of the Office of Programs, which included supervision of the agency's insurance fund (NCUSIF). Prior to joining NCUA, Mr. Filson was supervisor of the Credit Union Division of the Illinois Department of Financial Institutions. Mr. Filson is a magna cum laude graduate of Harvard University. In 1968 he received a BA/MA in Politics, Philosophy and Economics from Oxford University where he was a Rhodes Scholar. In 1981 he received a Masters of Management degree with distinction from Northwestern University.

Geoff Bacino (Executive Director, IS&DGA) was most recently the Public Information Officer for the Mayor's Office in Fort Wayne, Indiana. A Rockford, Illinois native, Mr. Bacino has Political Science degrees from Rock Valley College and Indiana University.

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FINANCIAL CONDITION OF THE BANK AND THRIFT INDUSTRIES

THURSDAY, OCTOBER 17, 1985

House of Representatives,
Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10:30 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Chairman St Germain; Representatives Annunzio, Hubbard, Barnard, Vento, Cooper, Kaptur, Wylie, Leach, McKinney, Wortley, Roukema, and Bereuter.

Also present: Representatives Carper and Chandler of the full committee.

Chairman St Germain. The subcommittee will come to order.

For many weeks this subcommittee has been probing the fundamental elements of deposit insurance reform. From the testimony of the top Federal supervisory officials, we have acquired an up-to-date understanding of the financial condition of depository institutions generally.

From the officials directly responsible for managing the day-to-day affairs of the Federal insuring funds, we have obtained needed information regarding the full resources of the Federal insurance funds. The testimony of academic and private experts, on financial soundness and deposit insurance, has acquainted the members of the subcommittee with a dozen or more separate deposit insurance reform proposals.

Today we hear from the Chairman of the Federal Savings and Loan Insurance Corporation. This agency insures over $750 billion in deposits and touches the lives of millions of Americans by providing the all-important assurance that savings and loan deposits are safe.

Let there be no mistake, this agency constitutes one of the foundation stones of the entire U.S. financial system and because its actions affect the credit decisions of thousands of savings and loan associations across this country, it is a major determinant of the economic health of our Nation.

This committee has tried consistently to give the Federal supervisory agencies the authority needed to deal with regulatory problems, even if we had to drag the agencies along. Once again this chairman—and I think this committee—is ready to lean over backward to make sure you have what you need to deal with the problems. But, I think it is important that we deal with real issues, the real solutions, and not suggest to the American public that a grab bag of assorted band-aids will mend the broken bones.

It is one thing for the Chairman of a supervisory agency to appear here and pronounce policy and it is quite another for the White House, the Office of Management and Budget and the Treasury Department to chime in with their opinions and solutions—or worse still, be conspicuous by their silence.

Frankly, I think we have some very serious problems in the financial community and among the insuring agencies of the Federal Government. However, I see little indication—none—that these problems are high on the agenda at the White House or OMB or Treasury.

I think it is time for the President to become involved if, indeed, it is the consensus of the administration that we have a major problem on our hands. These problems have grown over the past 5 years, and Congress should not be expected to be the entire cleanup crew.

This administration has been adept at seizing on economic statistics to claim credit. That is part of the political game and we expect it. But when an administration plays the heavy game on economic statistics, it has to accept the downside—and the statistics on problem and failed financial institutions and fortunes of the insuring funds are decidedly downside.

Dealing with these problems will take more than mirrors and gimmicks. It may require money or at least an indication of a willingness to come up with the funds if they are needed. The administration—not just its supervisory agencies—needs to make known publicly what it is willing to do or not willing to do to solve the problems of the financial industry.

I do not think we should move on any of this legislation until we have a clear picture of overall administration policy—short-term, as well as long-term—including what happens to FDIC and FSLIC if the President's balanced budget amendment prevails.

As presently structured, the balanced budget amendment could prevent the Congress from making appropriations available to replenish the insurance funds should that become necessary. In 1982, the Congress passed House Concurrent Resolution 290, which stated, in effect, that the full faith and credit of the Federal Government stood behind the insurance funds. The President's endorsement of the Gramm-Rudman balanced budget proposal would effectively negate this congressional statement of intent which has helped provide stability for the financial community.

Before we move further into the legislative thicket, we should know more about the administration's attitude toward Federal bank supervision. The information available to us indicates an attitude of callous disregard. The examination staffs of the FDIC and the Comptroller of Currency each was reduced from 1980 through 1984 by almost 300 positions. During the same period, the number of problem banks increased from 217 to 848. The examination staff of the Federal Home Loan Bank Board was reduced by 63 positions during the past 4 years—an unbelievable trend considering the galloping problems faced by that agency.

If this is the attitude of the administration toward bank supervision, then it becomes questionable just what all these new legislative proposals would mean in practice. We need some clear statement of purpose from the top and indication of just how far the administration will go in trying to solve the problems.

Balanced budgets and personnel reductions have great merit, but so do safe and sound financial institutions, solvent insurance funds and proper regulation.

At this point in the record I will insert two bills and their section-by-section analyses, H.R. 1680 and H.R. 2444, pertaining to the subject of today's hearing on "Deposit Insurance Reform."

[The text of H.R. 1680 and H.R. 2444 with attached analyses follow:]

99TH CONGRESS
1ST SESSION

H. R. 1680

To strengthen and refine the provisions of the Federal Home Loan Bank Act, the Home Owners' Loan Act of 1933 and the National Housing Act, to provide for more flexible premium assessment procedures, to improve insurance of accounts provisions, to establish priorities among claimants against the estates of failed institutions, to improve and clarify enforcement authority, to strengthen holding company provisions, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MARCH 21, 1985

Mr. ST GERMAIN (for himself and Mr. WYLIE) (by request) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

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A BILL

To strengthen and refine the provisions of the Federal Home Loan Bank Act, the Home Owners' Loan Act of 1933 and the National Housing Act, to provide for more flexible premium assessment procedures, to improve insurance of accounts provisions, to establish priorities among claimants against the estates of failed institutions, to improve and clarify enforcement authority, to strengthen holding company provisions, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Insured Institution Improvements Act of 1985".

TITLE I—INSURANCE OF ACCOUNTS

SEC. 101. This title may be cited as the "Savings Insurance Protection Act of 1985".

DEFINITIONS

SEC. 102. Section 401 of the National Housing Act (12 U.S.C. 1724) is amended—

(1) by amending subsection (a) to read as follows:

"(a) The term 'insured institution' means an institution having classes of accounts which are insured under this subchapter.";

(2) by amending subsection (c) to read as follows:

"(c)(1) Subject to the provisions of paragraph (2) of this subsection, the term 'insured account' means a share, certificate, or deposit account of a type approved by the Federal Savings and Loan Insurance Corporation which is held by an insured member in an insured institution and which is insured under the provisions of this title.

"(2) In furtherance of the purposes of this Act, the Federal Savings and Loan Insurance Corporation shall have authority and discretion to establish by regulation classes of accounts and to determine whether accounts in any such class constitute insured accounts."; and

(3) by adding a new subsection (e) at the end thereof as follows:

"(e) The term 'State' includes the District of Columbia, any territory of the United States, the Virgin Islands, and the Commonwealth of Puerto Rico.".

PRIMARY AND SECONDARY RESERVES

SEC. 103. Section 404(b) of the National Housing Act (12 U.S.C. 1727(b)) is amended by striking the words "except that under regulations prescribed by the Corporation such premium may be paid semiannually" in the second sentence of paragraph (1) thereof and inserting in lieu thereof: "or on such other periodic basis as the Board may establish by regulation".

SEC. 104. Section 404(c) of the National Housing Act (12 U.S.C. 1727(c)) is amended to read as follows:

"(c) The Corporation is further authorized to assess against each insured institution additional premiums for insurance as follows:

"(1) against all insured institutions, in an amount that does not exceed in any one year against any such institution so assessed, one-eighth of 1 per centum of the total amount of the accounts of its insured members, but only until the amount of such premiums equals the amount of all losses and expenses of the Corporation; and

"(2) notwithstanding any other provision of this subsection, against insured institutions whose asset investments, including the percentage of assets invested in any activity, exceed the authority granted to Federal associations under the Home Owners' Loan Act of 1933, as amended, and regulations promulgated pursuant thereto. In assessing additional premiums pursuant to this subsection (c)(2) the Corporation shall take into account the insured institutions' level of net worth as compared to its outstanding liabilities.".

TITLE II—ENFORCEMENT

SEC. 201. This title may be cited as the "Savings Institutions Supervisory Act of 1985".

CEASE AND DESIST PROCEEDINGS

SEC. 202. Section 407(e)(1) of the National Housing Act (12 U.S.C. 1730(e)(1)) is amended—

(1) by amending the first two sentences thereof read as follows:

"(1) If the Corporation is of the opinion that an insured institution or institution-related party is engaged or has engaged, or the Corporation determines that it has reasonable cause to believe that an insured institution or institution-related party is about to engage, in an unsafe or unsound practice in conducting the business of such insured institution, or if the Corporation has reasonable cause to believe that an insured institution or institution-related party is violating or has violated, or is about to violate, a law, rule, regulation, or any written agreement entered into with the Corporation, including any agreement entered into under section 1726 of this title, the Corporation may issue and serve upon such insured institution or institution-related party, a notice of charges in respect thereof. The notice shall contain a statement of the facts constituting the alleged violation or violations or the unsafe or unsound practice or practices, and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist therefrom should issue against the insured institution or institution-related party.";

(2) by amending the fifth and sixth sentences thereof to read as follows:

"In the event of such consent, or if based upon the record made at any such hearing the Corporation shall find that any violation or unsafe or unsound practice specified in the notice of charges has been established, the Corporation may issue and serve upon the insured institution or institution-related party an order to cease and desist from any such violation or practice. Such order may require the insured institution or institution-related party to cease and desist from the same, and further to take affirmative action to correct the conditions resulting from any such violation or practice."; and

(3) by adding at the end thereof the following:

"Such affirmative action may include, without limitation, restitution, rescission, the disposal of loans or assets, guarantees against loss, and/or other action as the Corporation deems to be appropriate in the circumstances.".

SEC. 203. Section 5(d)(2)(A) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(2)(A)) is amended—

(1) by amending the first two sentences thereof to read as follows:

"(A) If the Board is of the opinion that an association or association-related party is engaged or has engaged, or the Board determines that it has reasonable cause to believe that an association or association-related party is about to engage, in an unsafe or unsound practice in conducting the business of such association, or that an association or association-related party is violating or has violated, or the Board has reasonable cause to believe that an association or association-related party is about to violate, a law, rule, regulation, or any written agreement entered into with the Board, the Board may issue and serve upon such association or association-related party, a notice of charges in respect thereof. The notice shall contain a statement of the facts constituting the alleged violation or violations or the unsafe or unsound practice or practices and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist therefrom should issue against the association or association related party.".

(2) by amending the fifth and sixth sentences thereof to read as follows:

"In the event of such consent, or if based upon the record made at any such hearing the Board shall find that any violation or unsafe or unsound practice specified in the notice of charges has been established, the Board may issue and serve upon the association or association-related party an order to cease and desist from any such violation or practice. Such order may require the association or association-related party to cease and desist from the same, and further to take affirmative action to correct the conditions resulting from any such violation or practice."; and

(3) by adding at the end thereof the following:

"Such affirmative action may include, without limitation, restitution, rescission, the disposal of loans or assets, guarantees against loss, and/or such other action as the Board deems to be appropriate in the circumstances.".

SEC. 204. Section 407(e)(3) of the National Housing Act (12 U.S.C. 1730(e)(3)) is amended to read as follows:

"(3) This subsection and subsections (f), (g), (h), (j), (m), (n), (o), (p), (q), and (r) of this section shall apply also to any savings and loan holding company, and to any subsidiary (other than an insured institution) of a savings and loan holding company, as those terms are defined in section 1730a of this title, and to any service corporation or any subsidiary of a service corporation, whether wholly or partly owned, of an insured institution, in the same manner as they apply to an insured institution.".

SEC. 205. Section 5(d)(2)(C) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(2)(C)) is amended to read as follows:

"(C) This paragraph and paragraphs (3), (4), (5), (7), (8), (9), (10), (12) (A) and (B), (13), and (14) of this subsection shall apply to any savings and loan holding company, and to any subsidiary (other than an association) of a savings and loan holding company, as those terms are defined in section 1730a of this title, and to any service corporation or any subsidiary of a service corporation, whether wholly or partly owned, of an association in the same manner as they apply to an association.".

TEMPORARY CEASE AND DESIST ORDERS

SEC. 206. Section 407(f) of the National Housing Act (12 U.S.C. 1730(f)) is amended—

(1) by amending paragraphs 407(f)(1) and (2) to read as follows:

"(f)(1) Whenever the Corporation shall determine that the violation or threatened violation or that the unsafe or unsound practice of practices or threatened unsafe or unsound practice or practices specified in the notice of charges served upon an insured institution or institution-related party pursuant to paragraph (1) of subsection (e) of this section, or the continuation thereof, is likely to cause insolvency or dissipation of assets or earnings of the insured institution concerned or is likely to weaken the condition of the insured institution concerned or otherwise seriously prejudice the interests of its insured account holders or stockholders prior to the completion of proceedings conducted pursuant to paragraph (1) of subsection (e) of this section, the Corporation may issue a temporary order requiring the insured institution or instutition-related party to cease and desist from any such violation or practice and to take such affirmative action as the Corporation deems appropriate to prevent such insolvency, dissipation, condition, or prejudice pending completion of such proceedings. Such order shall become effective upon service upon the concerned insured institution or institution-related party, and unless set aside, limited, or suspended by a court in proceedings authorized by paragraph (3) of this subsection, shall remain effective and enforceable pending completion of the administrative proceedings initiated pursuant to such notice and until such time as the Corporation shall dismiss the charges specified in such notice, or if a cease-and-desist order is issued against the insured institution or institution-related party, until the effective date of any such order.

"(2) Whenever a notice of charges shall specify that an insured institution's books and records are so incomplete or inaccurate that the Corporation is unable with reasonable effort to determine the financial condition of that institution, the Corporation may issue a temporary order requiring the cessation of any institution activities as the Corporation shall deem appropriate until the completion of the proceedings conducted pursuant to paragraph (1) of subsection (e) of this section. Such order shall become effective upon service, and unless set aside, limited, or suspended by a court in proceedings authorized by paragraph (3) of this subsection, shall remain effective and enforceable pending completion of the administrative proceeding initiated pursuant to such notice or until, in the opinion of the Corporation, the institution's books and records are accurate and capable of reflecting the financial condition of the institution, which the Corporation may determine by examination or otherwise.

"(3) Within ten days after an insured institution or institution-related party has been served with a temporary cease-and-desist order, the party served may apply to the United States district court for the judicial district in which the principal office of the concerned institution is located, or the United States District Court for the District of Columbia, for an injunction setting aside, limiting or suspending the enforcement, operation, or effectiveness of such order pending the completion of the administrative proceedings pursuant to the notice of charges served upon said party under paragraph

(1) of subsection (e) of this section, and such court shall have jurisdiction to issue said injunction."; and

(2) by redesignating subsection (3) as subsection (4).

Sec. 207. Section 5(d)(3) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(3)) is amended—

(1) by amending subparagraphs 5(d)(3)(A) and (B) to read as follows:

"(3)(A) Whenever the Board shall determine that the violation or threatened violation or that the unsafe or unsound practice or practices or threatened unsafe or unsound practice or practices specified in the notice of charges served upon an association or any association-related party pursuant to paragraph (2)(A) of this subsection, or the continuation thereof, is likely to cause insolvency or dissipation of assets or earnings of the association concerned or is likely to weaken the condition of the association or otherwise seriously prejudice the interests of its savings account holders or stockholders prior to the completion of proceedings conducted pursuant to paragraph (2)(A) of this subsection, the Board may issue a temporary order requiring the association or association-related party to cease and desist from any such violation or practice and to take such affirmative action as the Board deems appropriate to prevent such insolvency, dissipation, condition, or prejudice pending completion of such proceedings. Such order shall become effective upon service upon the association or association-related party, and unless set aside, limited, or suspended by a court in proceedings authorized by subparagraph (C) of this paragraph, shall remain effective and enforceable pending completion of the administrative proceedings initiated pursuant to such notice and until such time as the Board shall dismiss the charges specified in such notice, or if a cease-and-desist order is issued against the association or association-related party, until the effective date of any such order.

"(B) Whenever a notice of charges shall specify that an association's books and records are so incomplete or inaccurate that the Board is unable with reasonable effort to determine the financial condition of that association, the Board may issue a temporary order requiring the cessation of any association activities as the Board shall deem appropriate until the completion of the proceedings conducted pursuant to paragraph (2)(A) of this subsection. Such order shall become effective upon service and unless set aside, limited, or suspended by a court in proceedings authorized by paragraph (C) of this subsection, shall remain effective and enforceable pending completion of the administrative proceeding initiated pursuant to such notice or until, in the opinion of the Board, the association's books and records are accurate and capable of reflecting the financial condition of the association, which the Corporation may determine by examination or otherwise.

"(C) Within ten days after an association or association-related party has been served with a temporary cease-and-desist order, the party served may apply to the United States district court for the judicial district in which the principal office of the concerned association is located, or the United States District Court for the District of Columbia, for an injunction setting aside, limiting, or suspending the enforcement, operation, or effectiveness of such order pending the completion of the administrative proceedings pursuant to the notice of charges served upon said party under paragraph (2)(A) of this subsection, and such court shall have jurisdiction to issue said injunction."; and

(2) by redesignating subsection 5(d)(3)(C) as subsection 5(d)(3)(D).

SUSPENSION, REMOVAL, OR PROHIBITION OF INSTITUTION-RELATED PARTIES

SEC. 208. Section 407(g) of the National Housing Act (12 U.S.C. 1730(g)) is amended to read as follows:

"(g)(1) Whenever the Corporation shall be of the opinion that—

"(A) any institution-related party has committed any violation of law, rule, regulation or a cease-and-desist order which has become final, or has engaged or participated in any unsafe or unsound practice in connection with an insured institution, or has committed or engaged in any act, omission, or practice which constitutes a breach of his fiduciary or professional duty;

"(B) an insured institution has suffered or will probably suffer financial loss or other damage or the interests of its insured account holders or stockholders have been or could be prejudiced by reason of such violation or practice or breach, or the institution-related party has received financial gain by reason of such violation or practice or breach; and

"(C) such violation or practice or breach is one involving personal dishonesty on the part of such institution-related party, or one that demonstrates a willful or continuing disregard for the safety or soundness of the insured institution,

the Corporation may serve upon such institution-related party a written notice of its intention to remove such party from his office or his position and/or to prohibit his further participation in any manner in the conduct of the affairs of such insured institution. For institution-related parties who are not holding an official office or who are no longer participating in the affairs of such insured institution at the time of service of the notice, the notice shall state the Corporation's intention to prohibit such person's further participation in any manner in the conduct of the affairs of the insured institution.

"(2) Whenever the Corporation shall determine that any institution-related party has evidenced either personal dishonesty or a willful or continuing disregard for the safety or soundness of another insured institution or other business enterprise by conduct or practice with respect to such other insured institution or business enterprise that resulted in financial loss or other damage to such other insured institution or business enterprise or that resulted in financial gain to such institution-related party, and, in addition, where such party has evidenced his unfitness to continue as an institution-related party, the Corporation may serve upon such institution-related party a written notice of its intention to remove him from office and/or to prohibit his further participation in any manner in the affairs of his institution.

"(3) Whenever, in the opinion of the Corporation, any institution-related party has committed a violation of the Depository Institutions Management Interlocks Act (12 U.S.C. 3201 et seq.), the Corporation may serve upon such party a written notice of its intention to remove him from office or to prohibit his further participation in any manner in the conduct of the affairs of the institution.

"(4) A notice of intention to remove shall contain a statement of the facts constituting grounds therefor, and shall fix a time and place at which a hearing will be held thereon. Such hearing shall be fixed for a date not earlier than thirty days nor later than sixty days after the date of service of such notice, unless an earlier or a later date is set by the Corporation at the request of (A) such party and for good cause shown, or (B) the Attorney General of the United States. Unless such institution-related party shall appear at the hearing in person or by a duly authorized representative, he shall be deemed to have consented to the issuance of an order of such removal and/or prohibition. In the event of such consent, or if upon the record made at any such hearing the Corporation shall find that any of the grounds specified in such notice has been established, the Corporation may issue such orders of suspension or removal from office, and/or prohibition from participation in the conduct of the affairs of the institution, as it may deem appropriate. Any such order shall become effective at the expiration of thirty days after service upon such institution and the institution-related party (except in the case of an order issued upon consent, which shall become effective at the time specified therein). Such order shall remain effective and enforceable except to such extent as it is stayed, modified, terminated, or set aside by action of the Corporation or a reviewing court.

"(5) In respect to any institution-related party referred to in paragraph (1), (2), or (3) of this subsection, the Corporation may, if it deems it necessary for the protection of the institution or of the interests of its insured members or of the

Corporation, by written notice to such effect served upon such institution-related party, suspend him from office and/or prohibit him from further participation in any manner in the conduct of the affairs of the institution. Such suspension and/or prohibition shall become effective upon service of such notice and, unless stayed by a court in proceedings authorized by paragraph (6) of this subsection, shall remain in effect pending the completion of the administrative proceedings pursuant to the notice served under paragraph (1), (2), or (3) of this subsection and until such time as the Corporation shall dismiss the charges specified in such notice, or, if an order of removal and/or prohibition is issued against the institution-related party, until the effective date of any such order. Copies of any such notice shall also be served upon the institution from which the suspension and/or prohibition is to be effective.

"(6) Within ten days after any institution-related party has been suspended from office and/or prohibited from participation in the conduct of the affairs of an insured institution under paragraph (4) of this subsection, such party may appy to the United States district court for the judicial district in which the principal office of the institution is located, or the United States District Court for the District of Columbia, for a stay of such suspension and/or prohibition pending the completion of the administrative proceedings pursuant to the notice served upon such institution-related party under paragraph (1), (2), or (3) of this subsection, and such court shall have jurisdiction to stay such suspension and/or prohibition.".

SEC. 209. Section 5(d)(4) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(4)) is amended to read as follows:

"(4)(A) Whenever the Board shall be of the opinion that—

"(i) any association-related party has committed any violation of law, rule, regulation, or a cease-and-desist order which has become final, or has engaged or participated in any unsafe or unsound practice in connection with an insured institution, or has committed or engaged in any act, omission, or practice which constitutes a breach of his fiduciary or professional duty;

"(ii) an association has suffered or will probably suffer financial loss or other damage or the interests of its savings account holders or stockholders have been or could be prejudiced by reason of such violation or practice or breach, or the association-related party has received financial gain by reason of such violation or practice or breach; and

"(iii) such violation or practice or breach is one involving personal dishonesty on the part of such association-related party, or one that demonstrates a willful or continuing disregard for the safety and soundness of the association,

the Board may serve upon such association-related party a written notice of its intention to remove such party from his office or his position and/or to prohibit his further participation in any manner in the conduct of the affairs of such insured institution. For association-related parties who are not holding an official office or who are no longer participating in the affairs of such association at the time of service of the notice, the notice shall state the Board's intention to prohibit such person's further participation in any manner in the conduct of the affairs of the insured institution.

"(B) Whenever the Board shall determine that any association-related party has evidenced either personal dishonesty or a willful or continuing disregard for the safety and soundness of another association or other business enterprise by conduct or practice with respect to such other association or business enterprise that resulted in financial loss or other damage to such other association or business enterprise or that resulted in financial gain to such association-related party, and, in addition, where such party has evidenced his unfitness to continue as an association-related party, the Board may serve upon such association-related party, a written notice of its intention to remove him from office and/or to prohibit his further participation in any manner in the affairs of his association.

"(C) Whenever, in the opinion of the Board, any association-related party has committed a violation of the Depository Institutions Management Interlocks Act (12 U.S.C. 3201 et seq.), the Board may serve upon such association-related party written notice of its intention to remove him from office or to prohibit his further participation in any manner in the conduct of the affairs of the association.

"(D) A notice of intention to remove and/or prohibit an association-related party shall contain a statement of the facts constituting grounds therefor, and shall fix a time and place at which a hearing will be held thereon. Such hearing shall be fixed for a date not earlier than thirty days nor less than sixty days after the date of service of such notice, unless an earlier or a later date is set by the Board at the request of (i) such association-related party and for good cause shown, or (ii) the Attorney General of the United States. Unless such party shall appear at the hearing in person or by a duly authorized representative, he shall be deemed to have consented to the issuance of an order of such removal and/or prohibition. In the event of such consent, or if upon the record made at any such hearing the Board shall find that any of the grounds specified in such notice has been established, the Board may issue such orders of suspension or removal from office, and/or prohibition from participation in the conduct of the affairs of the institution, as it may deem appropriate. Any such order shall become effective at the expiration of thirty days after service upon such institution and the association-related party (except in the case of an order issued upon consent, which shall become effective at the time specified therein). Such order shall remain effective and enforceable except to such extent as it is stayed, modified, terminated, or set aside by action of the Board or a reviewing court.

"(E) In respect to any association-related party, or any other person referred to in subparagraph (A), (B), or (C) of this paragraph, the Board may, if it deems it necessary for the protection of the association or the interests of its savings account holders, by written notice to such effect served upon such party, suspend him from office and/or prohibit him from further participation in any manner in the conduct of the affairs of the association. Such suspension and/or prohibition shall become effective upon service of such notice and, unless stayed by a court in proceedings authorized by subparagraph (F) of this paragraph, shall remain in effect pending the completion of the administrative proceedings pursuant to the notice served under subparagraph (A), (B), or (C) of this paragraph and until such time as the Board shall dismiss the charges specified in such notice, or, if an order of removal and/or prohibition is issued against the association-related party, until the effective date of any such order. Copies of any such notice shall also be served upon the association from which the suspension and/or prohibition is to be effective.

"(F) Within ten days after any association-related party has been suspended from office and/or prohibited from participation in the conduct of the affairs of an association under subparagraph (D) of this paragraph, such party may apply to the United States district court for the judicial district in which the principal office of the institution is located, or the United States District Court for the District of Columbia, for a stay of such suspension and/or prohibition pending the completion of the administrative proceedings pursuant to the notice served upon such association-related party under subparagraph (A), (B), or (C) of this subsection, and such court shall have jurisdiction to stay such suspension and/or prohibition.".

SUSPENSIONS AND REMOVALS BASED ON INDICTMENTS OR CONVICTIONS

SEC. 210. Section 407(h) of the National Housing Act (12 U.S.C. 1730(h)) is amended to read as follows:

"(h)(1) Whenever any institution-related party is charged in any information or indictment, or any complaint authorized by a United States attorney, with the commission of or participation in a crime involving dishonesty or a breach of trust, which is punishable by imprisonment for a term exceeding one year under State or Federal law, the Corporation may, if continued service or participation by the individual may pose a threat to the interests of an insured institution's accountholders, or may threaten to impair public confidence in the insured institution, by written notice served upon such institution-related party, suspend him from office or prohibit him from further participation in any manner in the conduct of the affairs of the insured institution. A copy of such notice also shall be served upon the insured institution to which such individual is or was related. Such suspension or prohibition shall remain in effect until such information, indictment, or complaint is finally disposed of or until terminated by the Corporation. In the event that a judgment of conviction with respect to the charge is entered against such institution-related party and at such time as such judgment is not subject to further appellate review, the Corporation may, if continued service or participation by the individual may pose a threat to the interests of the insured institution's accountholders, or may threaten to impair public confidence in the insured institution, issue and serve upon such institution-related party an order removing him from office and/or prohibiting him from participation in any manner in the conduct of the affairs of the insured institution to which he is or was related, except with the consent of the Corporation. A copy of such order also shall be served upon the insured institution, whereupon such individual shall cease to be an institution-related party of such institution. A finding of not guilty or other disposition of the charge shall not preclude the Corporation from thereafter instituting proceedings to remove and/or prohibit such institution-related party pursuant to paragraph (1), (2), (3), or (4) of subsection (g) of this section. Any notice of suspension or order of removal issued under this paragraph shall remain effective and outstanding until the completion of any hearing or appeal authorized under paragraph (2) of this subsection, unless terminated by the Corporation.

"(2) Within thirty days from service of any notice of suspension or order of removal and/or prohibition issued pursuant to paragraph (1) of this subsection, the institution-related party concerned may request in writing an opportunity to appear before the Corporation to show that the continued service to or participation in the conduct of the affairs of the institution by such individual does not, or is not likely to, pose a threat to the interests of the institution's depositors or threaten to impair public confidence in the institution. Upon receipt of any such request, the Corporation shall fix a time (not more than thirty days after receipt of such request, unless extended at the request of the institution-related party) and place at which the party may appear, personally or through counsel, before one or more members of the Corporation or designated employees of the Corporation to submit written materials (or, at the discretion of the agency, oral testimony) and oral argument. Within sixty days of such hearing, the Corporation shall notify the institution-related party whether the suspension or prohibition from participation in any manner in the conduct of the affairs of the institution will be continued, terminated or otherwise modified, or whether the order removing and/or prohibiting such party will be rescinded or otherwise modified. Such notification shall contain a statement of the basis for the Corporation's decision, if adverse to the institution-related party.".

SEC. 211. Section 5(d)(5) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(5)) is amended to read as follows:

"(5)(A) Whenever any association-related party is charged in any information or indictment, or any complaint authorized by a United States attorney, with the commission of or participation in a crime involving dishonesty or a breach of trust, which is punishable by imprisonment for a term exceeding one year under State or Federal law, the Board may, if continued service or participation by the individual may pose a threat to the interests of the association's depositors or may threaten to impair public confidence in the association, by written notice served upon such party, suspend him from office or prohibit him from further participation in any manner in the conduct of the affairs of the association. A copy of such notice also shall be served upon the association. Such suspension or prohibition shall remain in effect until such information, indictment, or complaint is finally disposed of or until terminated by the Board. In the event that a judgment of conviction with respect to such crime is entered against such association-related party, and at such time as such judgment is not subject to further appellate review, the Board may, if continued service or participation by the individual may pose a threat to the interests of the association's depositors or may threaten to impair public confidence in the association, issue and serve upon such association-related party an order removing him from office and/or prohibiting him from further participation in any manner in the conduct of the affairs of the association except with the consent of the Board. A copy of such order shall also be served upon such association, whereupon such individual shall cease to be an association-related party. A finding of not guilty or other disposition of the charge shall not preclude the Board from thereafter instituting proceedings to remove and/or probihit such institution-related party, pursuant to subparagraph (A), (B), (C), or (D) of paragraph (4). Any notice of suspension or order of removal issued under this subparagraph shall remain effective and outstanding until the completion of any hearing or appeal authorized under paragraph (C) hereof unless terminated by the Board.

"(B) If at any time, because of the suspension of one or more directors pursuant to this section, there shall be on the board of directors of an association less than a quorum of directors not so suspended, all powers and functions vested in or exercisable by such board shall vest in and be exercisable by the director or directors on the Board not so suspended, until such time as there shall be a quorum of the board of directors. In the event all of the directors of an association are suspended pursuant to this section, the Board shall appoint persons to serve temporarily as directors in their place and stead pending the termination of such suspension, or until such time as those who have been suspended cease to be directors of the association and their respective successors take office.

"(C) Within thirty days from service of any notice of suspension or order of removal and/or prohibition issued pursuant to subparagraph (A), the association-related party concerned may request in writing an opportunity to appear before the Board to show that the continued service to or participation in the conduct of the affairs of the association by such individual does not, or is not likely to, pose a threat to the interests of the association's depositors or threaten to impair public confidence in the association. Upon receipt of any such request, the Board shall fix a time (not more than thirty days after receipt of such request, unless extended at the request of the association-related party) and place at which the party may appear, personally or through counsel, before one or more members of the Board or designated employees of the Board to submit written materials (or, at the discretion of the agency, oral testimony) and oral argument. Within sixty days of such hearing, the Board shall notify the association-related party whether the suspension or prohibition from participation in any manner in the conduct of the affairs of the association will be continued, terminated or otherwise modified, or whether the order removing and/or prohibiting such party will be rescinded or otherwise modified. Such notification shall contain a statement of the basis for the Board's decision, if adverse to the association-related party. The Board is authorized to prescribe such rules as may be necessary to effectuate the purposes of this subsection.".

ANCILLARY PROVISIONS: SUBPOENA POWER

SEC. 212. Section 407(m)(2) of the National Housing Act (12 U.S.C. 1730(m)(2)) is amended to read as follows:

"(2) In connection with examinations of insured institutions and affiliates thereof, the Corporation, or its designated representatives, shall have power to administer oaths and affirmations and to examine and to take and preserve testimony under oath as to any matter concerning the affairs, assets, or ownership of any such institution or affiliate thereof, or of any entity that was an insured institution or affiliate thereof at the time of the transaction or conduct being examined, and to issue subpoenas and subpoenas duces tecum. The Corporation is authorized to enforce such subpoenas by applying to the United States district court for the judicial district, or the United States court in any territory, in which the principal office of the institution or affiliate thereof is located, or in which the witness resides or carries on business, or in the District of Columbia. Such courts shall have jurisdiction and power to order and require compliance with any such subpoena, and any failure to obey such an order of the court may be punished by such court as contempt thereof. Any person who shall, without just cause, fail or refuse to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, and other records, in obedience to the subpoena of the Corporation, shall be guilty of a misdemeanor and, upon conviction, shall be subject to a fine of not more than $1000 or to imprisonment for a term of not more than one year, or both.".

PENALTIES

SEC. 213. Section 407(p) of the National Housing Act (12 U.S.C. 1730(p)) is amended to read as follows:

"(p)(1) Any person against whom there is outstanding and effective any notice or order (which is an order that has become final) served upon such person under subsections (g) or (h) of this section or under sections 1464(d) (4) or (5) of this title, or under section 1818(e) of this title, and who—

"(A) participates in any manner in the conduct of the affairs of the institution from which he has been suspended, removed and/or prohibited, or directly or indirectly solicits or procures, or transfers or attempts to transfer, or votes or attempts to vote any proxies, consents, or authorizations in respect to any voting rights in such institution, or

"(B) without the prior written approval of the Corporation, votes for a director, or serves or acts as a director, officer, employee, or agent or otherwise participates in any manner in the conduct of the affairs of any institution the accounts of which are insured by the Corporation, or without the written prior approval of the appropriate Federal regulatory authority, engages in said conduct with respect to any other depository institution the accounts of which are insured by the Federal Deposit Insurance Corporation or any other agency of the Federal Government.

shall be guilty of a misdemeanor, and upon conviction, be fined not more than $5,000 or imprisoned for not more than one year, or both.

"(2) Except with the prior written consent of the Corporation, no person shall serve as an institution-related party who has been convicted of a criminal offense involving dishonesty or breach of trust. For each knowing violation of this prohibition, the institution involved shall be subject to a penalty of not more than $100 for each day this prohibition is violated, which the Corporation may recover by suit or otherwise for its own use.".

SEC. 214. Section 5(d)(12) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(12)) is amended to read as follows:

"(12)(A) Any person against whom there is outstanding and effective any notice or order (which is an order that has become final) served upon such person under subsections (4) or (5) of this section or under section 1730 (g) or (h) of this title or under section 1818(e) of this title and who—

"(i) participates in any manner in the conduct of the affairs of the association from which he has been suspended, removed and/or prohibited, or directly or indirectly solicits or procures, or transfers or attempts to transfer, or votes or attempts to vote any proxies, consents, or authorizations in respect to any voting rights in such association, or

"(ii) without the prior written approval of the Board votes for a director, or serves or acts as a director, officer, employee, or agent or otherwise participates in any manner in the conduct of the affairs of any depository institution the accounts of which are insured by the Corporation, or without the prior written approval of the appropriate Federal regulatory authority, engages in such conduct with respect to any other depository institution the accounts of which are insured by the Federal Deposit Insurance Corporation or any other agency of the Federal Government.

shall be guilty of a misdemeanor, and upon conviction, be fined not more than $5,000 or imprisoned for not more than one year, or both.

"(B) Except with the prior written consent of the Corporation, no person shall serve as an association-related party who has been convicted of a criminal offense involving dishonesty or breach of trust. For each knowing violation of this prohibition, the institution involved shall be subject to a penalty of not more than $100 for each day this prohibition is violated, which the Board may recover by suit or otherwise for its own use.".

DEFINITIONS

SEC. 215. Section 407(r) of the National Housing Act (12 U.S.C. 1730(r)) is amended—

(1) by adding at the end of paragraph (r)(1) thereof of the following:

"(E) The term 'unsafe or unsound practice' includes any action or omission, which is, in the opinion of the Corporation, contrary to generally accepted standards of prudent operation, whether relating to the institution's internal management or to any external matter, the possible consequence of which, if continued, may be abnormal risk or loss or damage to an insured institution or any subsidiary thereof, to its stockholders or account holders, or to the Corporation; and

"(F) The term 'institution-related party' means any director, officer, employee, agent, or other person participating in the conduct of the affairs of an insured institution, or of any service corporation or any subsidiary of a service corporation of an insured institution, whether wholly or partly owned, or of any savings and loan holding company or any subsidiary of a savings and loan holding company as those terms are defined in section 1730a of this title, and any person who, with respect to a particular insured institution has filed or who is required to file a change in control notice with the Corporation pursuant to subsection (q) of this section. The status of any person as an 'institution-related party' shall not be affected by the resignation, termination of employment, or other separation of such person from an insured institution."; and

(2) by adding at the end thereof the following:

"(5) As used in subsections (e), (f), (g), and (h) of this section, the term 'insured institution' means any institution the deposits of which are insured by the Corporation, any institution that retains deposits insured by the Corporation notwithstanding the termination of its status as an insured institution pursuant to this section, and a Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation.".

SEC. 216. Section 5(d)(13) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(13)) is amended—

(1) by adding at the end of subparagraph (A) thereof the following:

"(5) The term 'unsafe or unsound practice' includes any action or omission, which is, in the opinion of the Board, contrary to generally accepted standards of prudent operation, whether relating to the association's internal management or to any external matter, the possible consequence of which, if continued, may be abnormal risk or loss or damage to an association or any subsidiary thereof, to its stockholders or account holders, or to the Federal Savings and Loan Insurance Corporation.

"(6) The term 'association-related party' means any director, officer, employee, agent, or other person participating in the conduct of the affairs of an association, or of any service corporation or any subsidiary of a service corporation of an association, or of any savings and loan holding company as those terms are defined in section 1730a of this title, and any person who, with respect to a particular association, has filed or who is required to file a change in control notice with the Federal Savings and Loan Insurance Corporation pursuant to subsection (q) of section 1730 of this title. The status of any person as an 'associated-related party' shall not be affected by the resignation, termination of employment, or other separation of such person from an association."; and

(2) by adding at the end thereof the following:

"(C) As used in subsections (d) (2), (3), (4), and (5) of this section, the term 'association' includes any former association that retains deposits insured by the Federal Savings and Loan Insurance Corporation notwithstanding the termination of its status as an institution insured by such corporation, any Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation, and any former Federal savings bank that retains deposits insured by the Federal Deposit Insurance Corporation notwithstanding the termination of its status as an insured bank.".

SEC. 217. Section 407 of the National Housing Act (12 U.S.C. 1730), as amended by this Act, is amended by adding at the end thereof a new subsection (s) as follows:

"(s) The Corporation shall have the power and authority to apply for injunctive relief in the appropriate United States district court whenever it determines that the enforcement provisions of this section are insufficient to resolve adequately unsafe or unsound practices or violations or threatened violations of any of the provisions of this title or of any regulations promulgated thereunder that are applicable to insured institutions or institution-related parties.".

SEC. 218. Section 5(d) of the Home Owners' Loan Act (12 U.S.C. 1464(d)), as amended by this Act, is amended by adding at the end thereof a new paragraph (16) as follows:

"(16) The Board shall have the power and authority to apply for injunctive relief in the appropriate United States district court whenever it determines that the enforcement provisions of this section are insufficient to resolve adequately unsafe or unsound practices or violations or threatened violations of any of the provisions of this title or of any regulations promulgated thereunder that are applicable to associations or association-related parties.".

TITLE III—PAYMENT OF INSURANCE

SEC. 301. This title may be cited as the "Insurance Amendments of 1985".

SEC. 302. Section 405(b) of the National Housing Act (12 U.S.C. 1728(b)) is amended by striking out "which is surrendered and transferred to the Corporation" from the first sentence thereof, and by adding at the end thereof the following: "Notwithstanding any other provision of law, the Corporation, upon payment of insurance as provided in this subsection (b), shall be subrogated to all rights of the insured member to the extent of such payment.".

SEC. 303. Section 405 of the National Housing Act (12 U.S.C. 1728), as amended by section 302 of this Act, is amended by adding at the end thereof the following new subsection:

"(e) Notwithstanding any other provision of law, the Corporation may withhold payment of such portion of the insured deposit of any depositor in an institution in default as may be required to provide for the payment of any liability, which is due and unpaid and is determined on the date of default, (i) of such depositor as a stockholder of the institution, or (ii) of such depositor to the institution or its receiver, pending the determination and payment of such liability by such depositor or any other person liable therefor: *Provided*, That such liability does not include the liability of a borrower under a note or other obligation not in default on the date of default of the institution.".

SEC. 304. Section 406(b) of the National Housing Act (12 U.S.C. 1729(b)) is amended:

(1) by striking out the last sentence of paragraph (2) and inserting in lieu thereof the following: "Notwithstanding any other provision of law, such payment of insurance by the Corporation shall subrogate the Corporation with respect to such insured account to the extent of

such payment, but shall not affect any right which an insured member may have with respect to the uninsured portion of the member's account, if any, or any right which such insured member may have to participate in the distribution of the net proceeds remaining from the disposition of the assets of such association."; and

(2) by amending paragraph (3) thereof as follows:

"(3) As used in this section, the term 'Federal association' means a Federal savings and loan association or a Federal savings bank, the accounts of which are insured by the Corporation.".

TITLE IV—RECEIVERSHIP POWERS, AUTOMATIC STAY, AND PRIORITIES

SEC. 401. This title may be cited as the "Receivership Improvement Act of 1985".

SEC. 402. Section 406(d) of the National Housing Act (12 U.S.C. 1729(d)) is amended by adding at the end thereof the following: "Notwithstanding any other provision of law, in implementing the first sentence of this subsection (d), the Corporation as conservator, receiver or legal custodian shall not be required to furnish bond for any purpose and may employ such officers, agents, attorneys, and employees as deemed necessary or appropriate by the conservator, receiver, or legal custodian, and such persons shall be employees of the conservator, receiver, or legal custodian and not of the

United States, and all fees, compensation, and expenses of liquidation and administration thereof shall be fixed by the Corporation and may be paid by the Corporation out of assets coming into its possession as conservator, receiver, or legal custodian.".

SEC. 403. Section 406 of the National Housing Act (12 U.S.C. 1729), as amended by Section 304 of this Act, is further amended by adding at the end thereof the following new subsections:

"(g) No agreement, which tends to diminish or defeat the right, title, or interest of the Corporation as conservator, receiver or other legal custodian of an insured institution in any asset acquired in its capacity as such conservator, receiver or legal custodian, or acquired by the Corporation under subsection (f) of this section, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the institution and the person or persons claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the institution, (3) shall have been approved as to the transaction or type of transaction by the board of directors of the insured institution or its loan committee, and (4) shall have been, continuously, from the time of its execution, an official record of the insured institution.

"(h) Any property, wherever located, in which an insured institution, as of the appointment of receiver, has a legal or equitable interest, is property of the receivership estate, and any other party to which the receiver transfers such property shall receive such title as the receiver itself possesses.

"(i)(1) The appointment of a receiver by the Board for an insured institution pursuant to section 5(d)(6)(A) of the Home Owners' Loan Act of 1933 or section 406 of the National Housing Act operates as a stay, applicable to all entities, or—

"(A) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the receiver or insured institution, other than the filing and prosecution of a claim with the receiver and any appeal therefrom to the Board, that was or could have been commenced before the commencement of the receivership or that seeks to recover a claim against the insured institution that arose before the commencement of the receivership;

"(B) the enforcement, against the receiver or insured institution or any property of the receivership estate, of a judgment obtained before the commencement of the receivership;

"(C) any act to obtain possession of property of the receivership estate or from the receivership estate;

"(D) any act to create, perfect, or enforce any lien against property of the estate or to exercise control over property of the estate;

"(E) any act to create, perfect, or enforce against property of the receivership estate any lien to the extent that such lien secures a claim that arose before the commencement of the receivership;

"(F) any act to collect, assess, or recover a claim against the receiver or insured institution that arose before the commencement of the receivership;

"(G) the setoff of any debt owing to the insured institution that arose before the commencement of the receivership against any claim against the receiver or insured institution; and

"(H) the commencement or continuation of a proceeding before the United States Tax Court concerning the insured institution.

"(2) The appointment of the Corporation as receiver does not operate as a stay of—

"(A) the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power;

"(B) the enforcement of a judgment, other than a money judgment, obtained in an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power;

"(C) a setoff that constitutes the setoff of a claim against the insured institution for a 'margin payment', as defined in section 741(5) of title 11, United States Code, or 'settlement payment' as defined in section 741(8), of title 11, United States Code, arising out of a 'securities contract', as defined in section 741(7) of title 11, United States Code;

"(D) the exercise of a contractual right by a 'repo participant', as defined in section 101 of title 11, United States Code, (i) to cause the liquidation of a repurchase agreement or (ii) to set off any mutual debt and claim under or in connection with a repurchase agreement that constitutes a setoff of a claim against the insured institution for a margin payment or settlement payment as defined in subparagraph (C) above: *Provided,* That any liquidation of a repurchase agreement shall be accomplished in a commercially reasonable manner and any excess received by a repo participant over the stated repurchase price, including interest, if any, and reasonable cost of liquidation, shall be paid to the receiver;

"(E) the commencement of any action by the Secretary of the Department of Housing and Urban Development to foreclose a mortgage or deed of trust in any case in which the mortgage or deed of trust held by said Secretary is insured or was formerly insured under the National Housing Act and covers property, or combinations of property, consisting of five or more living units;

"(F) the issuance to the insured institution by a governmental unit of a notice of tax deficiency;

"(G) an act by a lessor to the insured institution under a lease of nonresidential real property that has terminated by the expiration of the stated term of the lease before the appointment of the receiver or during the receivership; or

"(H) the presentment of a negotiable instrument and the giving of notice of and protesting dishonor of such an instrument.

"(3) Except as provided in subparagraphs (4) and (5) of this subsection the stay of an act against property of the estate under paragraph (1) of this section continues until such property is no longer property of the estate and the stay of any other act continues until the termination of the receivership.

"(4) On request of a party in interest the Board shall grant relief from the stay provided under paragraph (1) of this subsection, such as by terminating, annulling, modifying, or conditioning such stay—

"(A) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

"(B) with respect to a stay of an act against property, if—

"(i) the insured institution does not have an equity interest in such property; and

"(ii) such property is not necessary to an effective reorganization.

"(5) Thirty days after a request under subparagraph (4) of this subsection for relief from the stay of any act against property of the estate under paragraph (1) of this subsection, such stay is terminated with respect to the party in interest making such request, unless the Board orders such stay be continued in effect pending, or as a result of, a final determination under subparagraph (4) of this subsection. The Board shall grant such relief from any stay provided under this subsection (h) as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is a final determination under subparagraph (4) of this subsection.

"(6) Notwithstanding any other provision of this subsection, the appointment of a receiver by the Board for an insured institution pursuant to section 5(d)(6)(A) of the Home Owners' Loan Act of 1933 or section 406 of the National Housing Act does not operate as a stay of any act by a Federal Home Loan Bank or its assignee to enforce a security interest in favor of a Federal Home Loan Bank or its assignee against the property of an insured institution or any affiliate thereof, which lien secures an obligation of the institution to the Federal Home Loan Bank if—

"(A) said lien has been obtained in compliance with regulations promulgated by the Board or the Corporation with respect to the collateralization of Bank advances; and

"(B) said security interest constitutes a valid security interest under the laws of the State in which the principal office of the insured institution is located.

"(7) Notwithstanding any other provision herein, or any other provision of law, State or Federal, or the constitution of any State, no security interest of a Federal Home Loan Bank or its assignee in property of an insured institution or any affiliate thereof shall be enjoined from enforcement, avoided, subordinated, or otherwise impaired because it was perfected subsequent to the making of the advance that it secures, because it was not perfected, or because of the exercise or performance by the Bank or any officer or employee thereof of a function of the Board or the Corporation, including any supervisory or regulatory function, authorized or assigned by the Board or the Corporation; such security interest of a Federal Home Loan Bank or its assignee shall be deemed a valid, enforceable, perfected secured claim having priority with respect to such property over all claims other than a claim secured by a valid security interest in such property that was perfected prior to such time, if any, as the security interest of the Federal Home Loan Bank was perfected; and in the event that such prior perfected security interest exists, the security interest of the Federal Home Loan Bank or its assignee shall be subordinate only to that of such lien creditor in the specific property that is the subject of dispute.

"(8) Any disposition by a Federal Home Loan Bank or its assignee of collateral securing an advance shall be effected in a commercially reasonable manner.

"(j) When adequate protection is required under subsection (i) of an interest of an entity in property, such adequate protection may be provided by—

"(1) the receiver's agreement to make periodic cash payments to such entity, to the extent that the stay under subsection (j) results in a decrease in the value of such entity's interest in such property;

"(2) the receiver's providing to such entity an additional or replacement lien to the extent that such results in a decrease in the value of such entity's interest in such property; or

"(3) the receiver's granting such other relief, as an administrative expense, as will result in the realization by such entity of the equivalent of such entity's interest in such property.

"(k)(1) A receiver appointed by the Board for an insured institution pursuant to section 5(d)(6)(A) of the Home Owners' Loan Act of 1933 or section 406 of the National Housing Act shall have the rights and powers of, or may avoid any transfer of property of the insured institution or any obligation incurred by the insured institution that is avoidable by—

"(A) a creditor that extends credit to the insured institution immediately prior to the appointment of the receiver, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor or lien exists;

"(B) a creditor that extends credit to the insured institution, immediately prior to the appointment of the receiver and obtains, at such time and with respect to such credit, an execution against the insured institution that is returned unsatisfied at such time, whether or not such a creditor exists;

"(C) a bona fide purchaser of real property other than fixtures from the insured institution, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer immediately prior to the appointment of the receiver, whether or not such a purchaser exists; or

"(D) an equity receiver.

"(2) The receiver may avoid any transfer of an interest of the insured institution in property or any obligation incurred by the insured institution that is voidable under applicable law by a creditor holding an unsecured claim that is allowable by the receiver.

"(3) The receiver may avoid the fixing of a statutory lien on property of insured institutions to the extent that such lien—

"(A) first becomes effective against the insured institution:

"(i) when an insolvency proceeding other than under this title concerning the insured institution is commenced;

"(ii) when a custodian, conservator, or receiver is appointed or authorized to take or takes possession of the insured institution;

"(iii) when the insured institution becomes insolvent;

"(iv) when the insured institution's financial condition fails to meet a specified standard; or

"(v) at the time of an execution against property of the insured institution levied at the instance of an entity other than the holder of such statutory lien;

"(B) is not perfected or enforceable against a bona fide purchaser that purchases such property immediately prior to the appointment of the receiver, whether or not such a purchaser exists;

"(C) is for rent; or

"(D) is a lien of distress for rent.

"(4) The receiver may avoid any transfer of an interest of the insured institution in property or any obligation incurred by the insured institution that was made or incurred, voluntarily or involuntarily, with actual intent to hinder, delay, or defraud any entity to which the insured institution was or became, on or after the date that such transfer was made or such obligation was incurred, indebted.

"(l) Notwithstanding any other provision of law, State or Federal, or the constitution of any State, in connection with the liquidation of insured institutions in default, the Corporation as receiver shall make provision for payment of unsecured claims against the estate of the institution in default proved to the satisfaction of the receiver or the Board in the following order:

"(1) Administrative expenses of the receiver, including the costs, expenses, and debts of the receiver;

"(2) Administrative expenses of the insured institution: *Provided,* That such expenses were incurred within thirty days prior to the receiver's taking possession, and that such expenses shall be limited to reasonable expenses incurred for services actually provided by accountants, attorneys, appraisers, or examiners that, in the opinion of the receiver, are of benefit to the receivership estate, and shall not include wages or salaries of employees of the Association;

"(3) Claims for wages and salaries, including vacation, sick leave pay, and contributions to employee benefit plans earned by an employee of the insured institution within thirty days prior to the appointment of the receiver up to a maximum of $2,000 per person;

"(4) Claims of governmental units for unpaid taxes; but no other claim of a governmental unit shall have a priority higher than that of the fifth category below;

"(5) Claims for withdrawable accounts, including those of the Corporation as subrogee or transferee, and all other claims, whether liquidated or unliquidated, which have accrued and become unconditionally fixed on or before the date of default, except as provided below in the succeeding paragraphs of this subsection;

"(6) Claims other than those that have accrued and become unconditionally fixed on or before the date of default, including claims for interest after the date of default on claims of the fifth category; and any claim based on an agreement for accelerated, stipulated, or liquidated damages, which claim did not accrue prior to the date of the default, shall be considered as not having accrued and become unconditionally fixed on or before the date of default;

"(7) Claims that have been subordinated in whole or in part to general creditor claims, which shall be given the priority specified in the written instruments that evidence such claims; and

"(8) Claims by holders of nonwithdrawable accounts, including stock, which shall have priority within this eighth category in accordance with the terms of the written instruments that evidence such claims.

"(m) Interest after the date of default on claims of the fifth category of subsection (l) shall be at a rate or rates adjusted monthly to reflect the average rate for United States Treasury bills with maturities of not more than ninety-one days during the preceding three months.

"(n) All unsecured claims of any category of priority described in (l)(1) through (l)(8) above shall be paid in full, or provision made for such payment, before any claims of lesser priority are paid; if there are insufficient funds to pay any class of claims of one priority in full, distribution to claimants in such class shall be made pro rata; and notwithstanding anything to the contrary herein, the receiver may at any time, and from time to time, prior to the payment in full of all claims of a class having higher priority, make such ratable distributions to claimants in priority classes (l) (1), (2), (3), (4), and (5) as the receiver believes are reasonably necessary to conduct the receivership: *Provided*, That the receiver determines that adequate funds exist or will be recovered during the receivership to pay in full all claims of any higher priority.".

SEC. 404. Section 5(d)(6)(D) of the Home Owners' Loan Act (12 U.S.C. 1464 (d)(6)(D)) is amended by striking the second and third sentences and inserting in lieu thereof the following: "The Board shall appoint, except as hereafter provided, only the Federal Savings and Loan Insurance Corporation as conservator or receiver for an association, and said Corporation shall have power to buy at its own sale as conservator or receiver, subject to approval by the Board. The Board may, without any requirement of notice, hearing, or other action, replace a conservator with a receiver, but any such replacement shall not affect any right which the association may have to obtain judicial review of the original appointment, except that any removal under this paragraph shall be removal of the conservator or receiver in office at the time of such removal.".

TITLE V—FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

SEC. 501. This title may be cited as the "Federal Savings and Loan Insurance Corporation Improvements Act of 1985".

SEC. 502. Section 9101 of title 31, United States Code, is amended—

(1) in paragraph (2) by redesignating subparagraphs (G) through (J) as (H) through (K), respectively, and by adding a new subparagraph as follows:

"(G) the Federal Savings and Loan Insurance Corporation."; and

(2) in paragraph (3) by striking out subparagraph (E) and by redesignating subparagraphs (F) through (M) as (E) through (L), respectively.

Sec. 503. Section 402(c) of the National Housing Act (12 U.S.C. 1725(c)) is amended—

(1) by striking out the period at the end of the fourth sentence of paragraph (5) thereof and by inserting in lieu thereof the following: ", as now in effect or hereafter enacted, including without limitation any restriction, statutory or otherwise, relating to personnel, personnel employment levels, or apportionment of expenses."; and

(2) by adding a new paragraph (6) at the end thereof as follows:

"(6) To issue such rules, regulations and orders as it deems necessary or appropriate to define the terms used in this Act which for purposes of this paragraph, includes, without limitation, the provisions of sections 407(q) and 408; to enable it to administer and carry out the purposes of this Act, including, but not limited to the regulation of risk-taking by insured institutions; and to require compliance therewith and prevent evasions thereof.".

SEC. 504. Section 406 of the National Housing Act (12 U.S.C. 1729) as amended by this Act, is amended by adding at the end thereof the following new subsection:

"(p) Expenditures of the Corporation to carry out the purposes of this Act shall not be or be deemed to be from or of appropriations, appropriated amounts, appropriated funds, or funds for purposes of title 31, United States Code, or any other provision of law.".

SEC. 505. Section 404 of the National Housing Act (12 U.S.C. 1727), as amended by this Act, is further amended by adding at the end thereof the following new subsection:

"(j) Except as provided in this section, no funds of any insured institution paid to or on deposit with the Corporation shall be subject to attachment, garnishment, or other legal process by creditors of any insured institution.".

SEC. 506. Section 407(k)(1) of the National Housing Act (12 U.S.C. 1730(k)(1)) is amended by inserting immediately after the words "State-chartered institution" in the first sentence thereof the phrase "pursuant to an appointment by State authorities".

TITLE VI—HOLDING COMPANIES

SEC. 601. This title may be cited as the "Holding Company Amendments of 1985".

SEC. 602. Section 408(c) of the National Housing Act (12 U.S.C. 1730a(c)) is amended:

(1) by inserting "(1)" immediately after the initial "(c)";

(2) by redesignating paragraphs (1) and (2) as (A) and (B) respectively; and

(3) by adding the following new paragraph at the end thereof:

"(2) Notwithstanding any other provision of law, no savings and loan holding company, or insured institution, directly or indirectly, or through one or more subsidiaries or one or more transactions, shall be engaged in the activities of an underwriter or of a market-maker in (i) equity securities, or (ii) debt securities other than those secured by interests in real estate or that are eligible to be underwritten by national banks.".

PROHIBITED TRANSACTIONS

SEC. 603. Section 408(d) of the National Housing Act (12 U.S.C. 1730a(d)) is amended by inserting in the first sentence thereof after "insured institution" the following: "or subsidiary thereof," and by inserting in subparagraph (1) thereof after "as authorized by law" the following: "in the case of investment by the insured institution, or other than the parent insured institution, in the case of investment by its subsidiary".

SEC. 604. Sections 408(d) (4) and (5) of the National Housing Act (12 U.S.C. 1730a(d) (4) and (5)) are amended to read as follows:

"(4) make any loan, discount, extension of credit to (A) any affiliate, other than an insured institution's service corporation subsidiary or a joint venture in which an insured institution's service corporation subsidiary is a general partner, provided that the other partners and other parties with an interest in the joint venture are not affiliates of the insured institution, except in a transaction authorized by subparagraph (A) of paragraph (6) of this subsection, or (B) any third party on the security of any property acquired from any affiliate, or with knowledge that the proceeds of any such loan, discount, or extension of credit, or any part thereof, are to be paid over to or utilized for the benefit of any affiliate: *Provided, however,* That a subsidiary insured institution, or subsidiary thereof, may make a loan, discount, or extension of credit to a third party on the security of property acquired from its service corporation, provided that no other affiliate has a direct or indirect interest in that service corporation other than through the subsidiary insured institution; and

"(5) guarantee the repayment of or maintain any compensating balances for any loan or extension of credit granted to any affiliate (other than a wholly owned service corporation) by any third party;".

SEC. 605. Section 408(e)(3) of the National Housing Act (12 U.S.C. 1730a(e)(3)) is amended—

(1) by striking out "or" in subparagraph (A); and

(2) by striking out the period in subparagraph (B) and inserting in lieu thereof a semicolon;

(3) by adding at the end thereof the following new subparagraphs:

"(C) result in a savings and loan holding company which is itself an uninsured institution, or which directly or indirectly has control of an uninsured institution; however, the Corporation may in its sole discretion, permit operation as, or control of, an uninsured institution to be acquired and/or retained for up to one year after control has been acquired of the insured institution or uninsured institution, whichever is later, if the Corporation specifically determines that such an extension would not represent an undue risk to the Corporation's insurance fund, or for a longer period if the Corporation specifically determines that such an extension beyond one year, including in perpetuity, assists the Corporation in preserving the Corporation's insurance fund or that such an extension would not represent an undue risk to such fund; or

"(D) result in the acquisition directly or indirectly, or through one or more transactions, of an insured institution by a company engaged in the activities of an underwriter of or market-maker in equity or debt securities, as defined by the Corporation, other than those representing interests in real estate or that are eligible to be underwritten by national banks.".

SEC. 606. Section 408(h) of the National Housing Act (12 U.S.C. 1730a(h)) is amended—

(1) by deleting paragraph (1) thereof; and

(2) by redesignating paragraphs (2) through (6) as (1) through (5) respectively.

SEC. 607. Section 408(h)(3) of the National Housing Act (12 U.S.C. 1730a(h)(4)), as amended and redesignated, is amended by striking out all that follows "to enforce compliance with this section or any rule, regulation or order thereunder," and inserting in lieu thereof the following: "and for such other relief as may be appropriate, including but not limited to the divestiture of any acquisition made in violation of this section, rescission of transactions effected in violation of this section, or restitution to persons suffering damage as a result of violations of this section. Upon proper showing, an injunction, decree, restraining order, order of divestiture, rescission, restitution, or other appropriate order shall be granted. No bond shall be required of the Corporation.".

SEC. 608. Section 408(m)(1)(B)(i) of the National Housing Act (12 U.S.C. 1730a(m)(1)(B)(i)) is amended to read as follows:

"(B)(i) Before making a determination to take any action under subparagraph (A) with respect to the merger or acquisition of a State chartered institution, the Corporation shall consult the State supervisor having principal jurisdiction of such acquired institution.".

TITLE VII—QUALIFIED THRIFT LENDERS

SEC. 701. This title may be cited as the "Qualified Thrift Lender Act of 1985".

INSURANCE ELIGIBILITY

SEC. 702. Section 403(a) of the National Housing Act (12 U.S.C. 1730(a)) is amended—

(1) by inserting in paragraph (2) after "accounts of" the following: "any institution which is a qualified thrift lender, as defined in paragraph (3) of this subsection, including"; and

(2) by adding at the end thereof the following:

"(3)(A) Except as provided in subparagraph (B) of this paragraph, a qualified thrift lender is an institution that, as determined by the Corporation, has an aggregate of not less than 60 per centum of its assets (including investments made by any subsidiary of such an institution) invested in—

"(i) cash,

"(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof,

"(iii) liquid assets of the type required to be maintained pursuant to regulations issued by the Federal Home Loan Bank Board under section 5A of the Federal Home Loan Bank Act,

"(iv) certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

"(v) loans secured by a deposit or share of a member,

"(vi) loans, equity positions, or securities related to domestic residential real property, manufactured housing, or real property used primarily for church purposes, including loans to facilitate the construction, improvement or equipping of domestic residential real property, manufactured housing, multifamily dwellings, property used primarily for church purposes, and shelter-providing facilities as set forth in subdivision (viii) hereof, "(vii) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property,

"(viii) loans secured by an interest in educational, health, or welfare institutions of facilities, including shelter-providing facilities for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

"(ix) loans made for the payment of expenses of college or university education or vocational training,

"(x) property acquired through the liquidation of defaulted loans described in clauses (vi), (vii) or (viii), and

"(xi) property used by an institution in the conduct of its business:

Provided, That such institution does not thereafter fall below such percentage on an average basis in three out of every four quarters in three out of every five years: *Provided further*, That the 60 per centum requirement shall be reduced for any averaging period by the amount of loans relating to domestic residential real property or manufactured housing, originated and sold during such period by such institution or any subsidiary thereof, by such a percentage as the Corporation may determine appropriate.

"(B) For a twenty-year period following the date of enactment of this paragraph, 'qualified thrift lender' shall also include an institution chartered as a mutual savings bank under State laws: *Provided*, That the Corporation determines that—

"(i) the institution has an aggregate of not less than 50 per centum of its assets (including investments made by any subsidiary of such an institution) invested in assets of the type set forth in subparagraph (A) of this paragraph, and

"(ii) the institution does not decrease the percentage of its assets invested in accordance with subparagraph (A) of this paragraph below the percentage it held on the date of enactment of this paragraph, and increases such percentage of its assets invested in accordance with said subparagraph (A) by an amount at least equal to the following percentages of the difference between 60 per centum and the percentage of its assets invested in accordance with said subparagraph (A) on the date of enactment of this paragraph within the following time periods from the date of enactment of this paragraph:

"(I) within five years, 25 per centum;

"(II) within ten years, 50 per centum;

"(III) within fifteen years, 75 per centum.

"(C) Any institution that fails to maintain its status as a qualified thrift lender, as determined by the Corporation, may not thereafter be a qualified thrift lender for a period of five years.

"(D) The Corporation may conduct examinations, to carry out the provisions of this paragraph: *Provided,* That with respect to a federal stock savings bank insured by the Federal Deposit Insurance Corporation, the Corporation shall rely to the maximum extent possible on examinations conducted by that agency.".

ELIGIBILITY FOR ADVANCES

SEC. 703. Section 10 of the Federal Home Loan Bank Act (12 U.S.C. 1430) is amended by adding at the end thereof the following new subsection:

"(e) Except as the Board may prescribe, no member, the deposits of which are insured by the Federal Savings and Loan Insurance Corporation or the Federal Deposit Insurance Corporation, shall be eligible for advances unless such member is a qualified thrift lender as defined in section 403(a)(3) of the National Housing Act.".

INVESTMENT AUTHORITY

SEC. 704. Section 5(c)(4)(B) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(c)(4)(B)) is amended by striking the remainder of the sentence after "except that" and inserting in lieu thereof the following: "the limitation contained herein shall be 5 per centum of the assets of an association which is a qualified thrift lender as defined in section 403(a)(3) of the National Housing Act.".

BRANCHING

SEC. 705. Section 5(r)(1) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(r)(1)) is amended—

(1) by striking out the first sentence "domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954 or meets the asset composition test imposed by subparagraph (c) of that section on institutions seeking so to qualify." and inserting in lieu thereof the following: "qualified thrift lender as defined in section 403(a)(3) of the National Housing Act."; and

(2) by striking out in the second sentence "domestic building and loan association under said section 7701(a)(19)." and inserting in lieu thereof the following: "qualified thrift lender as defined in said section 403(a)(3).".

EMERGENCY THRIFT ACQUISITIONS

SEC. 706. Section 408(m)(5)(C)(i) of the National Housing Act (12 U.S.C. 1730a(m)(5)(C)(i)) is amended by striking out "domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954 or does not meet the asset composition test imposed by subparagraph (c) of that section on institutions seeking so to qualify," and inserting in lieu thereof the following: "qualified thrift lender as defined in section 403(a)(3) of this Act,".

UNITARY ACTIVITIES

SEC. 707. Section 408(n) of the National Housing Act (12 U.S.C. 1730a(n)) is amended by striking out "domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954," and inserting in lieu thereof the following: "qualified thrift lender as defined in section 403(a)(3) of this Act,".

TITLE VIII—MISCELLANEOUS

FEDERAL HOME LOAN BANK BOARD; CREATION, ETC.

SEC. 801. Section 17 of the Federal Home Loan Bank Act (12 U.S.C. 1437) is amended by adding at the end thereof the following new subsection:

"(c) Notwithstanding any other provision of law, in accordance with board regulations to prevent conflicts of interest, the board may accept payment and reimbursement, in cash or in kind, from Federal or non-Federal agencies, organizations (including industry trade groups), and individuals for travel, subsistence, and other necessary expenses incurred by board members and employees in attending meetings and conferences concerning the functions or activities of the board. Any payment or reimbursement accepted shall be deposited in the Treasury of the United States, and from time to time may be withdrawn therefrom to defray such expenses. The amount of travel, subsistence, and other necessary expenses for members and employees paid or reimbursed under this subsection may exceed per diem amounts established in official travel regulations, but the board may limit such amounts. For the purposes of this subsection, 'board' shall include the Federal Savings and Loan Insurance Corporation: *Provided*, That payments or reimbursements received by such Corporation shall be deposited pursuant to chapter 91 of title 31.".

DEMAND ACCOUNTS

SEC. 802. Section 5(b)(1) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(b)(1)) is amended—

(1) by amending subparagraph (1)(A) to read as follows:

"(1)(A) An association may raise capital in the form of such deposits, shares, or other accounts (all of which are referred to in this section as accounts) as are authorized by its charter or by regulations of the Board, and may issue such passbooks, certificates, or other evidence of accounts as are so authorized."; and

"(2) by striking out the first and second sentences of subparagraph (B).

SEC. 803. Section 1832(a)(1) of title 12, United States Code, is amended to read as follows:

"(1) Nothwithstanding any other provision of law, a depository institution is authorized to permit the owner of a deposit or account on which interest or divid[illegible]re paid to make withdrawals by negotiable or transferable instruments for the purpose of making transfers to third parties.".

SEC. 804. Section 19 of the Federal Home Loan Bank Act (12 U.S.C. 1439) is amended by adding at the end thereof the following: "Notwithstanding any other provision of law, former employers of participants in the Board's professional accounting fellows programs may pay such participants their actual expenses for relocation to Washington, District of Columbia, to facilitate their participation in such programs, and program participants may accept such payments.".

SEC. 805. The Garn-St Germain Depository Institutions Act of 1982, Public Law 95-320, is amended as follows:

(1) in section 141 by striking "three" and inserting in lieu thereof "six"; and

(2) in section 206 by striking "three" and inserting in lieu thereof "six".

SEC. 806. The National Housing Act and the Federal Deposit Insurance Act are amended as follows:

(1) section 403 of the National Housing Act (12 U.S.C. 1726), as amended by this Act, is further amended by adding at the end thereof the following new subsection:

"(c) If, upon application, and pursuant to a plan of conversion to an institution of a type eligible to be an insured institution, the Corporation, in its discretion, determines to grant insurance of accounts to a savings bank that is an insured bank (as the term 'insured bank' is defined in section 3(h) of the Federal Deposit Insurance Act), such insurance shall become effective at such time as the Corporation stipulates, at which time such institution automatically shall lose its status as such an insured bank. No change of deposit insurance agencies from the Federal Deposit Insurance Corporation to the Corporation shall be treated, for the purposes of section 18(i) of the Federal Deposit Insurance Act, as involving a conversion to a noninsured bank or institution, except that the Corporation shall provide the Federal Deposit Insurance Corporation with notification of any application that, if granted, would involve such a change of deposit insurance agencies, shall consult with the Federal Deposit Insurance Corporation before disposing of the application, and shall provide the Federal Deposit Insurance Corporation with notification of the determination with respect to such application."; and

(2) section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended:

(A) by amending paragraph (c)(12) thereof to read as follows:

"(12) The provisions of this subsection shall not apply to any transaction where the acquiring, assuming or resulting institution is an insured Federal savings bank or an institution insured by the Federal Savings and Loan Insurance Corporation, except that any insured bank involved in the transaction shall notify the Corporation in writing at least thirty days prior to consummation of the transaction and, if any approval by the Federal Home Loan Bank Board or required in connection therewith, such approving authority shall provide the Corporation with notification of the application for approval, shall consult with the Corporation before disposing of the application, and shall provide notification to the Corporation of the determination with respect to said application."; and

(B) by adding at the end of subsection (i) thereof the following new paragraph:

"(5) Nothing in this subsection shall apply to conversion of an insured bank to an insured institution pursuant to section 403(a) of the National Housing Act (12 U.S.C. 1726(a)).".

Sec. 807. The first sentence of section 7(d) of the Federal Home Loan Bank Act (12 U.S.C. 1427(d)) is amended by inserting before the period at the end thereof the following: ": *Provided*, That the Board is authorized to increase or decrease the terms of directors of each bank to provide for staggered terms for such directors".

Sec. 808. Section 407(q)(8)(B) of the National Housing Act (12 U.S.C. 1730(q)(8)(B) is amended to read as follows:

"(B) 'control' means the power, directly or indirectly (i) to influence or direct the management or policies of an insured institution, as such terms may be further defined by regulations of the Corporation, or (ii) to vote 25 per centum or more of any class of voting securities of an insured institution.".

H.R. 1680

SECTION BY SECTION ANALYSIS

Short Title

Section 1. This section states the title of the Act as the "Insured Institutions Improvements Act of 1985."

Title I--Insurance of Accounts

Section 101. Section 101 of the bill provides that Title I may be cited as the "Savings Insurance Protection Act of 1985."

Section 102. Section 102 of the bill amends subsections (a) and (c) of section 401 of the National Housing Act (12 U.S.C. 1724) to enable the Federal Home Loan Bank Board, as operating head of the Federal Savings and Loan Insurance Corporation, to establish by rule classes of accounts and to determine whether accounts in any such class constitute insured accounts. The purpose of the amendment is to clarify the authority of the Board to balance through rulemaking its statutory mandates to insure the accounts of institutions eligible for insurance and to safeguard the integrity of the Insurance Fund. In particular, the amendment clarifies the statutory authority for the Board's brokered funds rule, which limits the availability of pass-through insurance for funds deposited by deposit brokers, and would better enable the Board to prevent the evasion of that rule. The amendment specifically provides that the authority and discretion of the Board are to be exercised in furtherance of the purposes of Title IV of the National Housing Act. This section also makes a conforming change to the definition of "state" to harmonize various provisions of the National Housing Act. The Corporation's insurance powers extend to U.S. territories, the District of Columbia and Puerto Rico, but the National Housing Act does not consistently refer to all these jurisdictions.

Section 103. Section 103 permits the FSLIC to assess insurance premiums on a periodic basis, as determined by the FSLIC.

Section 104. Section 104 authorizes the FSLIC to assess an additional premium against institutions which engage in activities not authorized for federal associations or which exceed percentage of asset limitations applicable to federal associations on authorized activities.

Title II--Enforcement

Section 201. Section 201 provides that this title may be cited as the "Savings Institutions Supervisory Act of 1985."

Section 202. This section restates the Corporation's cease and desist authority contained in section 407(e) of the National Housing Act, as it relates to insured institutions and individuals, but replaces the former reference to "director, officer, employee, agent, or other person participating in the conduct of the affairs" of an insured institution with the phrase "institution-related party" as defined in section 215(a). Section 202(c) clarifies the meaning of the phrase "affirmative action to correct the conditions resulting from" a violation or unsafe or unsound practice as used in that section, to include restitution, rescission, the disposal of loans or assets, guarantees against loss and such other action as the Corporation may deem appropriate in the circumstances. The references throughout the section to unsafe or unsound practices are unchanged, although a definition of unsafe or unsound practice is now included in section 215(a).

Section 203. This section makes the same changes to section 5(d)(2) of the Home Owners' Loan Act, which is applicable to federal savings and loan associations, as does section 202 for institutions insured by the Corporation. The corresponding term "association-related party," is defined at section 216(a).

Sections 204 and 205. These sections broaden the reach of the Corporation's and the Board's cease-and-desist authority to second-tier and partly owned service corporations of insured institutions.

Section 206. The first paragraph of section 206(a) restates the Corporation's existing authority to issue temporary cease-and-desist orders in cases of statutory or regulatory violations or unsafe or unsound practices. The existing requirement that the Corporation determine that a violation or unsound practice is likely to cause insolvency, substantial dissipation of assets or earnings or a serious weakening of the condition of an institution has been changed to remove the modifiers "substantial" and "serious" in such emergency cases where temporary orders are required. The second paragraph is new authority to issue a temporary order to halt an institution's business activities whenever the Corporation is unable to determine the financial condition of such institution because of the disarray or lack of books and records. In both types of cases, the institution or institution-related party served with a temporary order has ten days to challenge the temporary order in U.S. district court.

Section 207. This section makes the same amendments to the Board's authority to issue temporary cease-and-desist orders against federal associations and association related parties as does section 206 for insured institutions.

Section 208. This paragraph clarifies the existing grounds for removal of institution officials by reorganizing section 407(g) of the National Housing Act into more organized subparagraphs. Because of the new definition of institution-related party (see section 215(a)), more individuals now are subject to the

Corporation's authority in this area. Because certain of those individuals such as attorneys, accountants and appraisers will not be officers or directors of insured institutions, the reference to "breach of fiduciary duties" in subsection (g)(1) is not appropriate for such individuals, so a corresponding reference to breach of "professional" duties has been added. Subsection (2) of section 407(g), which contains the grounds necessary to initiate removal or prohibition action against persons at one institution for their misconduct while serving at another institution or business enterprise, has been simplified and the grounds made uniform with those set forth in subsection (g)(1). Clarifying language also has been added to recognize the fact that current officers and directors are "removed and prohibited," while persons not holding an office -- either because they participate in the institution's affairs in some other manner or because they have left their former positions -- are only "prohibited." This language, along with the new definition of institution-related party at section 215(a), clarifies the Corporation's continuing jurisdiction over officers and directors who resign.

Section 209. This section makes the same amendments to the Home Owners' Loan Act as does section 208 to the National Housing Act.

Sections 210 and 211. These sections insert the references to "institution-related party" and "association-related party," respectively, in section 407(h) of the National Housing Act and section 5(d)(5) of the Home Owners' Loan Act, which permit suspensions when officials are indicted for felonies involving dishonesty or breach of trust, and removals when they are convicted of such felonies. Otherwise, there are no substantive changes to these provisions.

Section 212. This section amends the Corporation's statutory subpoena power at section 407(m)(2) of the National Housing Act to clarify that it includes inquiries into the affairs, assets, and/or ownership of insured institutions, including inquiries after an institution has ceased to be insured by the Corporation (such as following receivership) so long as the institution was insured by the Corporation at the time of the transactions or conduct being examined. The section also adds new penalties for failure to comply with subpoenas issued by the Corporation or its designated representatives.

Section 213. Section 213 expands the provisions of section 407(p) of the National Housing Act to reach the broader category of "institution-related parties" as defined in section 215. Individuals who have been removed from office and/or prohibited from further participation in any federally insured savings and loan institution or bank may not participate in any manner in the conduct of the affairs of the institution from which they have been removed and/or prohibited; and, without the approval of the appropriate federal supervisory agency, such persons may not serve as directors, officers, employees or agents or otherwise participate in the affairs of any federally insured depository institution. Previously, individuals removed from one FSLIC-insured institution were banned from serving as officers or directors at another FSLIC-institution without prior FSLIC approval. However, such individuals were free to move to FDIC insured banks, and individuals removed by one of the federal banking agencies could move to FSLIC insured institutions without restriction. Section 213 requires the prior approval of the appropriate federal supervisory agency before any such individual may be hired by or otherwise participate in the affairs of any federally insured depository institution.

Section 214. This section makes the same amendments to the Home Owners' Loan Act as does section 213 to the National Housing Act.

Sections 215 and 216. These sections add clarifying definitions of "unsafe or unsound practice," "institution-related party" and "association-related party." Included in the latter definitions are directors, officers, employees, agents, and other persons participating in the conduct of the affairs of institutions, service corporations, holding companies, and holding company subsidiaries, and individuals who have filed or who are required to file change in control notices with the Corporation.

Sections 217 and 218. Section 217 adds to the National Housing Act, and section 218 adds to the Home Owners' Loan Act, a grant of authority for the Corporation and the Board, respectively, to apply to U.S. district courts for injunctive relief to halt violations of those acts or regulations promulgated thereunder whenever administrative remedies are unable to adequately resolve such violations or unsafe or unsound practices.

Title III--Payment of Insurance

Section 301. Section 301 provides that this title may be cited as the "Insurance Amendments of 1985."

Section 302. Section 302 eliminates the requirement, unnecessary in light of subsequent amendments described herein, that an account be surrendered and transferred to the Corporation before payment of insurance on such account, and also provides that the Corporation shall, where it pays insurance of accounts of a defaulted institution, be subrogated to the claims of insured members by operation of law when and to the extent that such insurance payment has been made.

Section 303. Section 303 provides that the Corporation may withhold payment of insurance to insured members to the extent of liability of a member, but not including any liability of a borrower not in default.

Section 304. Section 304 makes conforming amendments to ensure consistency between the subrogation provisions of section 405(b), as amended by section 302, and section 406 of the

National Housing Act. This section also harmonizes section 406 of the National Housing Act with Section 5 of the Home Owners' Loan Act requiring that the FDIC be appointed receiver for an FDIC insured savings bank.

Title IV--Receivership Powers

Section 401. Section 401 provides that this title may be cited as the "Receivership Improvement Act of 1985."

Section 402. Section 402 provides that the Corporation, in connection with its activities as receiver, shall not be required to furnish any bond, shall have authority to employ persons as it deems appropriate to conduct the business of the receivership, and that all expenses relating to such receivership activities may be paid out of the receivership funds.

Section 403. Section 403 strengthens the Corporation's position as receiver by rendering ineffective many "side deals" entered into improperly by officers, directors, employees, agents, persons participating in the conduct of the institution and persons filing a change of control notice without the approval of the board of directors of such institutions. It also provides that any property in which an insured institution in receivership asserts a legal or equitable interest shall be property of the receivership estate. This section further provides for an automatic stay on all claims against the receivership estate analogous to that provided under the Bankruptcy Code, including provisions for adequate protection of such claimants, and excludes the security interests of Federal Home Loan Banks from the automatic stay or from any equitable subordination that might arise from Bank activities as agent of the Board or the Corporation. This section also clarifies the receiver's rights to assume the position of a lien creditor, bona fide purchaser or equity receiver against transferees of property of an institution in default and specifies, as a matter of pre-emptive federal law, priorities of unsecured claims against the receivership estate.

Section 404. This section clarifies the authority of the FSLIC to accept an appointment as a conservator of a federal association.

Title V--Federal Savings and Loan Insurance Corporation

Section 501. Section 501 provides that this title may be cited as the "Federal Savings and Loan Insurance Corporation Improvements Act of 1985."

Section 502. Section 502 provides that the Corporation shall be treated as a "mixed-ownership Government corporation" under section 9101 of title 31 of the United States Code.

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Section 503. Section 503 clarifies the Corporation's status as exempt from restrictions, statutory or otherwise, concerning personnel or apportionment of expenses; and clarifies and affirms the Corporation's general rulemaking authority with respect to implementation of the National Housing Act, including but not limited to the authority to define terms used in that Act and to regulate risk-taking activities by insured institutions. This authority applies to the savings and loan holding company and the mutual to stock conversion provisions of the National Housing Act.

Section 504. Section 504 provides that expenditures by the Corporation to carry out the purposes of the National Housing Act shall not be deemed to be appropriations under title 31 of the United States Code.

Section 505. This section clarifies that funds deposited with the FSLIC are available only for use by the FSLIC in carrying out its statutory purposes.

Section 506. This section provides that a federal forum is available to the FSLIC when the Bank Board appoints it as receiver of a state-chartered association and that a state forum is appropriate when a state authority so designates.

Title VI--Holding Companies

Holding Company Activities

Section 601. Section 601 provides that this title may be cited as the "Holding Company Amendments of 1985."

Section 602. This section prohibits savings and loan holding companies, and insured institutions regardless of whether or not they are controlled by a holding company, from directly or indirectly engaging in the activities of an underwriter or market-maker in (i) equity securities or (ii) debt securities other than those secured by interests in real estate or that are eligible to be underwritten by national banks.

Prohibited Transactions

Section 603. This section extends the current prohibitions on transactions between insured institutions and their parent savings and loan holding company and affiliates to transactions between subsidiaries of insured institutions and their parent savings and loan holding company and affiliates. The exception for investment by the insured institution in stocks, bonds, notes and other obligations of its service corporation has been extended to except investment by subsidiaries of the insured institution in the stock, bonds, notes and other obligations of its parent insured institution.

Section 604. Section 604 clarifies the intent of the current service corporation exception allowing the insured institution to make a loan to a third party secured by real estate acquired from the institution's wholly-owned service corporation by replacing the wholly-owned requirement with a requirement that no affiliate other than the insured institution and/or its subsidiaries have a direct or indirect controlling interest in that service corporation. Consistent with the overall expansion of the prohibitions in section 603 to include transactions between subsidiaries of insured institutions, this exception has been extended to subsidiaries of insured institutions. The requirement that the Corporation's prior approval must be obtained for such service corporation transactions has been deleted. The service corporation exception has also been restricted to service corporations which are not themselves insured institutions. In addition, the current provision that prohibits an insured institution, or, as added in section 602, a subsidiary thereof, from guaranteeing the repayment of or maintaining compensating balances for any loan granted to any affiliate by any third party has been amended to except transactions involving a loan to a wholly-owned service corporation of the insured institution or its subsidiary.

Acquisitions

Section 605. This section prohibits the FSLIC from approving a transaction which would result in a savings and loan holding company that is itself an uninsured institution or that has control of an uninsured institution, unless authorized by the FSLIC for up to one year after control has been acquired of the insured or uninsured institution, whichever is later, if the FSLIC determines that it would not represent an undue risk to the FSLIC's insurance fund or for a longer period, including perpetually, if the FSLIC determines that it would assist in preserving its insurance fund. This section also prohibits the FSLIC from approving an acquisition of an insured institution by a company engaged in the activities of an underwriter or market maker in (i) equity securities or (ii) debt securities other than those secured by interests in real estate or that are eligible to be underwritten by national banks.

Section 606. This section makes conforming changes to the FSLIC's rulemaking authority with respect to the savings and loan holding company provisions of the National Housing Act which is subsumed by the broad grant of authority contained in section 503 of the bill.

Section 607. Section 607 adds to the FSLIC's administrative enforcement authority the power to require rescission of transactions in violation of the National Housing Act, and to require restitution to persons suffering damages as a result of such violations.

Section 608. This section amends the emergency acquisition authority provided in section 123 of the Garn-St Germain Depository Institutions Act of 1982 (Pub. L. 97-320, 96 Stat. 1469), to clarify that acquisitions of federal institutions are not subject to prior consultation with the state banking authorities. This provision confirms the legislative history of this section (S. Rep. No. 97-536, 97th Cong., 2d Sess. 7 (1982)) and will prevent future court interpretations to the contrary. See Hartigan v. FHLBB, 746 F.2d 1300 (7th Cir. 1984).

Title VII--Qualified Thrift Lenders

Section 701. Section 701 provides that this title may be cited as the "Qualified Thrift Lender Act of 1985."

Section 702. This section conditions eligibility for FSLIC insurance by non-federal associations and FDIC-insured federal savings banks upon meeting the definition of a "qualified thrift lender." The definition is designed to insure a significant, continuing emphasis on housing and housing-related activities. A "qualified thrift lender" is required to maintain at least 60 percent of assets in specific housing and housing-related investments and certain liquid assets. An institution which fails to maintain "qualified thrift lender" status is ineligible to reattain such status for a period of five years.

The list of qualifying assets is sufficiently diverse to allow flexibility on the part of institution management to develop its own housing focus. The assets listed as qualifying include all loans, equity positions or securities related to domestic residential real estate or manufactured housing (including all investments in mortgage-related securities, both of the asset participation and pay-through bond type), all assets now incorporated in section 7701(a)(19)(C) of the Internal Revenue Code, as well as all investments related to shelter-providing facilities such as hospitals, nursing homes and student dormitories, all investments in items that qualify as short-term liquid assets pursuant to section 5A of the Federal Home Loan Bank Act, and qualifying assets held by a thrift's subsidiary. In addition, in order to recognize the contribution of thrifts participating in the secondary market, this section permits the Board to reduce the 60 percent averaging requirement for any relevant period by a percentage of loans related to residential real estate and manufactured housing originated and sold by the thrift or its subsidiary during that period.

To provide sufficient time for state chartered mutual savings banks to conform with the new "qualified thrift lender" test, the bill allows for a gradual restructuring of their asset portfolios over a twenty year period. Additionally, the bill requires that, with respect to federal stock savings banks insured by the FDIC, the FSLIC must rely, to the maximum extent possible, upon examinations conducted by the FDIC.

Section 703. This section limits the eligibility for Federal Home Loan Bank advances by members with deposits insured by the FSLIC or FDIC to "qualified thrift lenders" as defined in the National Housing Act, except as the Board prescribes by rule or regulation.

Section 704. This section increases the service corporation investment authority of federal associations with a demonstrated emphasis on housing finance by increasing the authorized level of investment therein from three to five percent of assets for federal "qualified thrift lenders." This section also deletes the current proviso requiring that associations devote half of the investment under this authority which exceeds one percent for community development purposes.

Section 705. This section substitutes the "qualified thrift lender" test for the current "domestic building and loan association" test contained in section 7701(a)(19)(C) of the Internal Revenue Code with regard to limits on out-of-state branching by federal associations.

Section 706. This section requires that a bank or bank holding company making an out-of-state acquisition of an insured institution under the authority of section 408(m) of the National Housing Act must conform to the branching limitations applicable to banks in the State in which the acquired insured institution is located if the thrift is not a "qualified thrift lender" as defined in section 403 of the National Housing Act, as amended by section 702 of this bill. Under current law, this limitation is linked to qualifying status as a "domestic building and loan association" under section 7701(a)(1)(C) of the Internal Revenue Code.

Section 707. This section likewise substitutes the "qualified thrift lender" test for the "domestic building and loan association" test with regard to limits on the activities of unitary savings and loan holding companies. Under the present law, the activities of a unitary savings and loan holding company with a non-qualifying insured institution subsidiary are limited to the same extent as those of multiple savings and loan holding companies and their subsidiaries.

Title VIII--Acceptance of Travel Support; Demand Deposits

Section 801. Section 801 of the bill amends section 17 of the Federal Home Loan Bank Act (12 U.S.C. 1437) to grant to the Board, subject to Board rules to prevent conflicts of interest, the authority to accept from federal and nonfederal sponsors payment or reimbursement for travel, subsistence, and other necessary expenses incurred by Board members and staff in attending meetings and conferences concerning the functions or activities of the Board. This amendment makes applicable to the Board and the FSLIC travel and subsistence expense provisions substantially similar to those applicable to the Securities and Exchange Commission under section 4(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78d(e)).

Section 802. This section would revise section 5(b)(1) of the Home Owners' Loan Act to permit federal associations to accept demand deposits without limitation. At present, federal associations may accept demand deposits only from persons or organizations that have established a business relationship with the association, except that such accounts can also be accepted from a corporate, commercial, business or agricultural entity for the sole purpose of effectuating payments thereto by a non-business customer.

Section 803. This amendment deletes the requirement that negotiable order of withdrawal ("NOW") accounts be issued only to individuals or to non-business type organizations.

Section 804. This section would exempt the Board's professional accounting fellows from the prohibition against payment of a government employee's moving expenses by a former employer. 18 U.S.C. 209. This exemption is substantially the same as that provided for White House fellows and Securities and Exchange Commission fellows.

Section 805. This section extends for three years the sunset date for the emergency provisions of title I and the net worth certificate provisions of title II of the Garn-St Germain Depository Institutions Act of 1982.

Section 806. This section clarifies the manner in which institutions may transfer insurance coverage between the FSLIC and FDIC insurance funds.

Section 807. This section permits the staggering of terms for Federal Home Loan Bank directors from the same state.

Section 808. Section 808 of the bill amends the change in control provisions of the National Housing Act to clarify the Corporation's right to define what is actual control of an [illegible]-insured institution. The Corporation and the banking agencies each have devised regulatory presumptions of control for individuals purchasing less than 25 percent of an institution's stock but who demonstrate that they exert a controlling influence over an institution. The amendment would clarify that such presumptions are an integral part of the statutory definition and would avoid frivolous suits by persons challenging the regulatory definitions of the agencies.

A BILL

To strengthen and refine the provisions of the Federal Home Loan Bank Act, the Home Owners' Loan Act of 1933 and the National Housing Act, to provide for more flexible premium assessment procedures, to improve insurance of accounts provisions, to establish priorities among claimants against the estates of failed institutions, to improve and clarify enforcement authority, to strengthen holding company provisions, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America assembled.

SHORT TITLE

SECTION 1. This Act may be cited as the "Insured Institutions Improvements Act of 1985".

TITLE I--INSURANCE OF ACCOUNTS

SEC. 101. This title may be cited as the "Savings Insurance Protection Act of 1985".

DEFINITIONS

SEC. 102. Section 401 of the National Housing Act (12 U.S.C. 1724) is amended--

(1) by amending subsection (a) to read as follows:

"(a) The term "insured institution" means an institution having classes of accounts which are insured under this subchapter.";

(2) by amending subsection (c) to read as follows:

"(c)(1) Subject to the provisions of paragraph (2) of this subsection, the term "insured account" means a share, certificate, or deposit account of a type approved by the Federal Savings and Loan Insurance Corporation which is held by an insured member in an insured institution and which is insured under the provisions of this title.

"(2) In furtherance of the purposes of this Act, the Federal Savings and Loan Insurance Corporation shall have authority and discretion to establish by regulation classes of accounts and to determine whether accounts in any such class constitute insured accounts."; and

(3) by adding a new subsection (e) at the end thereof as follows:

"(e) The term "State" includes the District of Columbia, any territory of the United States, the Virgin Islands, and the Commonwealth of Puerto Rico.".

PRIMARY AND SECONDARY RESERVES

SEC. 103. Section 404(b) of the National Housing Act (12 U.S.C. 1727(b)) is amended by striking the words "except that under regulations prescribed by the Corporation such premium may be paid semiannually" in the second sentence of paragraph (1) thereof and inserting in lieu thereof: "or on such other periodic basis as the Board may establish by regulation".

SEC. 104. Section 404(c) of the National Housing Act (12 U.S.C. 1727(c)) is amended to read as follows:

"(c) The Corporation is further authorized to assess against each insured institution additional premiums for insurance as follows:

> "(1) against all insured institutions, in an amount that does not exceed in any one year against any such institution so assessed, one-eighth of one per centum of the total amount of the accounts of its insured members, but only until the amount of such premiums equals the amount of all losses and expenses of the Corporation; and
>
> "(2) notwithstanding any other provision of this subsection, against insured institutions whose asset investments, including the percentage of assets invested in any activity, exceed the authority granted to federal associations under the Home Owners' Loan Act of 1933, as amended, and regulations promulgated pursuant thereto. In assessing additional premiums pursuant to this subsection (c)(2) the Corporation shall take into account the insured institutions' level of net worth as compared to its outstanding liabilities".

TITLE II--ENFORCEMENT

SEC. 201. This title may be cited as the "Savings Institutions Supervisory Act of 1985".

CEASE AND-DESIST PROCEEDINGS

SEC. 202. Section 407(e)(1) of the National Housing Act (12 U.S.C. 1730(e)(1)) is amended--

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(1) by amending the first two sentences thereof to read as follows:

"(1) If the Corporation is of the opinion that an insured institution or institution-related party is engaged or has engaged, or the Corporation determines that it has reasonable cause to believe that an insured institution or institution-related party is about to engage, in an unsafe or unsound practice in conducting the business of such insured institution, or if the Corporation has reasonable cause to believe that an insured institution or institution-related party is violating or has violated, or is about to violate, a law, rule, regulation, or any written agreement entered into with the Corporation, including any agreement entered into under section 1726 of this title, the Corporation may issue and serve upon such insured institution or institution-related party, a notice of charges in respect thereof. The notice shall contain a statement of the facts constituting the alleged violation or violations or the unsafe or unsound practice or practices, and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist therefrom should issue against the insured institution or institution-related party.";

(2) by amending the fifth and sixth sentences thereof to read as follows:

"In the event of such consent, or if based upon the record made at any such hearing the Corporation shall find that any violation or unsafe or unsound practice specified in the notice of charges has been established, the Corporation may issue and serve upon the insured institution or institution-related party an order to cease and desist from any such violation or practice. Such order may require the insured institution or institution-related party to cease and desist from the same, and further to take affirmative action to correct the conditions resulting from any such violation or practice."; and

(3) by adding at the end thereof the following:

"Such affirmative action may include, without limitation, restitution, rescission, the disposal of loans or assets, guarantees against loss, and/or other action as the Corporation deems to be appropriate in the circumstances.".

SEC. 203. Section 5(d)(2)(A) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(2)(A)) is amended--

(1) by amending the first two sentences thereof to read as follows:

"(A) If the Board is of the opinion that an association or association-related party is engaged or has engaged, or the Board determines that it has reasonable cause to believe that an association or association-related party is about to engage, in an unsafe or unsound practice in conducting the business of such association, or that an association or association-related party is violating or has violated, or the Board has reasonable cause to believe that an association or association related party is about to violate, a law, rule, regulation, or any written agreement entered into with the Board, the Board may issue and serve upon such association or association-related party, a notice of charges in respect thereof. The notice shall contain a statement of the facts constituting the alleged violation or violations or the unsafe or unsound practice or practices and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist therefrom should issue against the association or association related party.";

(2) by amending the fifth and sixth sentences thereof to read as follows:

"In the event of such consent, or if based upon the record made at any such hearing the Board shall find that any violation or unsafe or unsound practice specified in the notice of charges has been established, the Board may issue and serve upon the association or association-related party an order to cease and desist from any such violation or practice. Such order may require the association or association-related party to cease and desist from the same, and further to take affirmative action to correct the conditions resulting from any such violation or practice."; and

(3) by adding at the end thereof the following:

"Such affirmative action may include, without limitation, restitution, rescission, the disposal of loans or assets, guarantees against loss, and/or such other action as the Board deems to be appropriate in the circumstances.".

SEC. 204. Section 407(e)(3) of the National Housing Act (12 U.S.C. 1730(e)(3)) is amended to read as follows:

"(3) This subsection and subsections (f), (g), (h), (j), (m), (n), (o), (p), (q), and (r) of this section shall apply also to any savings and loan holding company, and to any subsidiary (other than an insured institution) of a savings and loan holding company, as those terms are defined in section 1730a of this title, and to any service corporation or any subsidiary of a service corporation, whether wholly or partly owned, of an insured institution, in the same manner as they apply to an insured institution.".

SEC. 205. Section 5(d)(2)(C) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(2)(C)) is amended to read as follows:

"(C) This paragraph and paragraphs (3), (4), (5), (7), (8), (9), (10), (12)(A) and (B), (13), and (14) of this subsection shall apply to any savings and loan holding company, and to any subsidiary (other than an association) of a savings and loan holding company, as those terms are defined in section 1730a of this title, and to any service corporation or any subsidiary of a service corporation, whether wholly or partly owned, of an association in the same manner as they apply to an association.".

TEMPORARY CEASE AND DESIST ORDERS

SEC. 206. Section 407(f) of the National Housing Act (12 U.S.C. 1730(f)) is amended--

(1) by amending paragraphs 407(f)(1) and (2) to read as follows:

"(f)(1) Whenever the Corporation shall determine that the violation or threatened violation or that the unsafe or unsound practice or practices or threatened unsafe or unsound practice or practices specified in the notice of charges served upon an insured institution or institution-related party pursuant to paragraph (1) of subsection (e) of this section, or the continuation thereof, is likely to cause insolvency or dissipation of assets or earnings of the insured institution concerned or is likely to weaken the condition of the insured institution concerned or otherwise seriously prejudice the interests of its insured account holders or stockholders prior to the completion of proceedings conducted pursuant to paragraph (1) of subsection (e) of this section, the Corporation may issue a temporary order requiring the insured institution or institution-related party to cease and desist from any such violation or practice and to take such affirmative action as the Corporation deems appropriate to prevent such insolvency, dissipation, condition, or prejudice pending completion of such proceedings. Such order shall become effective upon service upon the concerned insured institution or institution-related party, and unless set aside, limited, or suspended by a court in proceedings authorized by paragraph (3) of this subsection, shall remain effective and enforceable pending completion of the administrative proceedings initiated pursuant to such notice and until such time as the Corporation shall dismiss the charges specified in such notice, or if a cease-and-desist order is issued against the insured institution or institution-related party, until the effective date of any such order.

"(2) Whenever a notice of charges shall specify that an insured institution's books and records are so incomplete or inaccurate that the Corporation is unable with reasonable effort to determine the financial condition of that institution, the Corporation may issue a temporary order requiring the cessation of any institution activities as the Corporation shall deem appropriate until the completion of the proceedings conducted pursuant to paragraph (1) of subsection (e) of this section. Such order shall become effective upon service, and unless set aside, limited, or suspended by a court in proceedings authorized by paragraph (3) of this subsection, shall remain effective and enforceable pending completion of the administrative proceeding initiated pursuant to such notice or until, in the opinion of the Corporation, the institution's books and records are accurate and capable of reflecting the financial condition of the institution, which the Corporation may determine by examination or otherwise.

"(3) Within ten days after an insured institution or institution related party has been served with a temporary cease and desist order, the party served may apply to the United States district court for the judicial district in which the principal office of the concerned institution is located, or the United States District Court for the District of Columbia, for an injunction setting aside, limiting or suspending the enforcement, operation, or effectiveness of such order pending the completion of the administrative proceedings pursuant to the notice of charges served upon said party under paragraph (1) of subsection (e) of this section, and such court shall have jurisdiction to issue said injunction."; and

(2) by redesignating subsection (3) as subsection (4).

SEC. 207. Section 5(d)(3) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(3)) is amended--

(1) by amending subparagraphs 5(d)(3)(A) and (B) to read as follows:

"(3)(A) Whenever the Board shall determine that the violation or threatened violation or that the unsafe or unsound practice or practices or threatened unsafe or unsound practice or practices specified in the notice of charges served upon an association or any association-related party pursuant to paragraph (2)(A) of this subsection, or the continuation thereof, is likely to cause insolvency or dissipation of assets or earnings of the association concerned or is likely to weaken the condition of the association or otherwise seriously prejudice the interests of its savings account holders or stockholders prior to the completion of proceedings conducted pursuant to paragraph (2)(A) of this subsection, the Board may issue a temporary order requiring the association or association-related party to cease and desist from any such violation or practice and to take such affirmative action as the Board deems appropriate to prevent such insolvency, dissipation, condition, or prejudice pending completion of such proceedings. Such order shall become effective upon service upon the association or association-related party, and unless set aside, limited, or suspended by a court in proceedings authorized by subparagraph (C) of this paragraph, shall remain effective and enforceable pending completion of the administrative proceedings initiated pursuant to such notice and until such time as the Board shall dismiss the charges specified in such notice, or if a cease-and-desist order is issued against the association or association-related party, until the effective date of any such order.

"(B) Whenever a notice of charges shall specify that an association's books and records are so incomplete or inaccurate that the Board is unable with reasonable effort to determine the financial condition of that association, the Board may issue a temporary order requiring the cessation of any association activities as the Board shall deem appropriate until the completion of the proceedings conducted pursuant to paragraph (2)(A) of this subsection. Such order shall become effective upon service and unless set aside, limited, or suspended by a court in proceedings authorized by paragraph (C) of this subsection, shall remain effective and enforceable pending completion of the administrative proceeding initiated pursuant to such notice or until, in the opinion of the Board, the association's books and records are accurate and capable of reflecting the financial condition of the association, which the Corporation may determine by examination or otherwise.

"(C) Within ten days after an association or association-related party has been served with a temporary cease-and-desist order, the party served may apply to the United States district court for the judicial district in which the principal office of the concerned association is located, or the United States District Court for the District of Columbia, for an injunction setting aside, limiting, or suspending the enforcement, operation, or effectiveness of such order pending the completion of the administrative proceedings pursuant to the notice of charges served upon said party under paragraph (2)(A) of this subsection, and such court shall have jurisdiction to issue said injunction."; and

(2) by redesignating subsection 5(d)(3)(C) as subsection 5(d)(3)(D).

SUSPENSION, REMOVAL, OR PROHIBITION OF INSTITUTION-RELATED PARTIES

SEC. 208. Section 407(g) of the National Housing Act (12 U.S.C. 1730(g)) is amended to read as follows:

"(g)(1) Whenever the Corporation shall be of the opinion that--

"(A) any institution-related party has committed any violation of law, rule, regulation or a cease and desist order which has become final, or has engaged or participated in any unsafe or unsound practice in connection with an insured institution, or has committed or engaged in any act, omission, or practice which constitutes a breach of his fiduciary or professional duty; and

"(B) an insured institution has suffered or will probably suffer financial loss or other damage or the interests of its insured account holders or stockholders have been or could be prejudiced by reason of such violation or practice or breach, or the institution-related party has received financial gain by reason of such violation or practice or breach; and

"(C) such violation or practice or breach is one involving personal dishonesty on the part of such institution-related party, or one that demonstrates a willful or continuing disregard for the safety or soundness of the insured institution,

"the Corporation may serve upon such institution-related party a written notice of its intention to remove such party from his office or his position and/or to prohibit his further participation in any manner in the conduct of the affairs of such insured institution. For institution-related parties who are not holding an official office or who are no longer participating in the affairs of such insured institution at the time of service of the notice, the notice shall state the Corporation's intention to prohibit such person's further participation in any manner in the conduct of the affairs of the insured institution.

"(2) Whenever the Corporation shall determine that any institution-related party has evidenced either personal dishonesty or a willful or continuing disregard for the safety or soundness of another insured institution or other business enterprise by conduct or practice with respect to such other insured institution or business enterprise that resulted in financial loss or other damage to such other insured institution or business enterprise or that resulted in financial gain to such institution-related party, and, in addition, where such party has evidenced his unfitness to continue as an institution-related party, the Corporation may serve upon such institution-related party a written notice of its intention to remove him from office and/or to prohibit his further participation in any manner in the affairs of his institution.

"(3) Whenever, in the opinion of the Corporation, any institution-related party has committed a violation of the Depository Institutions Management Interlocks Act (12 U.S.C. 3201 et seq.), the Corporation may serve upon such party a written notice of its intention to remove him from office or to prohibit his further participation in any manner in the conduct of the affairs of the institution.

"(4) A notice of intention to remove shall contain a statement of the facts constituting grounds therefor, and shall fix a time and place at which a hearing will be held thereon. Such hearing shall be fixed for a date not earlier than thirty days nor later than sixty days after the date of service of such notice, unless an earlier or a later date is set by the Corporation at the request of (A) such party and for good cause shown, or (B) the Attorney General of the United States. Unless such institution-related party shall appear at the hearing in person or by a duly authorized representative, he shall be deemed to have consented to the issuance of an order of such removal and/or prohibition. In the event of such consent, or if upon the record made at any such hearing the Corporation shall find that any of the grounds specified in such notice has been established, the Corporation may issue such orders of suspension or removal from office, and/or prohibition from participation in the conduct of the affairs of the institution, as it may deem appropriate. Any such order shall become effective at the expiration of thirty days after service upon such institution and the institution-related party (except in the case of an order issued upon consent, which shall become effective at the time specified therein). Such order shall remain effective and enforceable except to such extent as it is stayed, modified, terminated, or set aside by action of the Corporation or a reviewing court.

"(5) In respect to any institution-related party referred to in paragraph (1), (2) or (3) of this subsection, the Corporation may, if it deems it necessary for the protection of the institution or of the interests of its insured members or of the Corporation, by written notice to such effect served upon such institution-related party, suspend him from office and/or prohibit him from further participation in any manner in the conduct of the affairs of the institution. Such suspension and/or prohibition shall become effective upon service of such notice and, unless stayed by a court in proceedings authorized by paragraph (6) of this subsection, shall remain in effect pending the completion of the administrative proceedings pursuant to the notice served under paragraph (1), (2) or (3) of this subsection and until such time as the Corporation shall dismiss the charges specified in such notice, or, if an order of removal and/or prohibition is issued against the institution-related party, until the effective date of any such order. Copies of any such notice shall also be served upon the institution from which the suspension and/or prohibition is to be effective.

"(6) Within ten days after any institution-related party has been suspended from office and/or prohibited from participation in the conduct of the affairs of an insured institution under paragraph (4) of this subsection, such party may apply to the United States district court for the judicial district in which the principal office of the institution is located, or the Untied States District Court for the District of Columbia, for a stay of such suspension and/or prohibition pending the completion of the administrative proceedings pursuant to the notice served upon such institution-related party under paragraph (1), (2) or (3) of this subsection, and such court shall have jurisdiction to stay such suspension and/or prohibition.".

SEC. 209. Section 5(d)(4) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(4)) is amended to read as follows:

"(4)(A) Whenever the Board shall be of the opinion that--

"(i) any association-related party has committed any violation of law, rule, regulation or a cease and desist order which has become final, or has engaged or participated in any unsafe or unsound practice in connection with an insured institution, or has committed or engaged in any act, omission, or practice which constitutes a breach of his fiduciary or professional duty; and

"(ii) an association has suffered or will probably suffer financial loss or other damage or the interests of its savings account holders or stockholders have been or could be prejudiced by reason of such violation or practice or breach, or the association-related party has received financial gain by reason of such violation or practice or breach; and

"(iii) such violation or practice or breach is one involving personal dishonesty on the part of such association-related party, or one that demonstrates a willful or continuing disregard for the safety and soundness of the association,

"the Board may serve upon such association-related party a written notice of its intention to remove such party from his office or his position and/or to prohibit his further participation in any manner in the conduct of the affairs of such insured institution. For association-related parties who are not holding an official office or who are no longer participating in the affairs of such association at the time of service of the notice, the notice shall state the Board's intention to prohibit such person's further participation in any manner in the conduct of the affairs of the insured institution.

"(B) Whenever the Board shall determine that any association-related party has evidenced either personal dishonesty or a willful or continuing disregard for the safety and soundness of another association or other business enterprise by conduct or practice with respect to such other association or business enterprise that resulted in financial loss or other damage to such other association or business enterprise or that resulted in financial gain to such association-related party, and, in addition, where such party has evidenced his unfitness to continue as an association-related party, the Board may serve upon such association-related party, a written notice of its intention to remove him from office and/or to prohibit his further participation in any manner in the affairs of his association.

"(C) Whenever, in the opinion of the Board, any association-related party has committed a violation of the Depository Institutions Management Interlocks Act (12 U.S.C. 3201 et seq.), the Board may serve upon such association-related party written notice of its intention to remove him from office or to prohibit his further participation in any manner in the conduct of the affairs of the association.

"(D) A notice of intention to remove and/or prohibit an association-related party shall contain a statement of the facts constituting grounds therefor, and shall fix a time and place at which a hearing will be held thereon. Such hearing shall be fixed for a date not earlier than thirty days nor later than sixty days after the date of service of such notice, unless an earlier or a later date is set by the Board at the request of (i) such association-related party and for good cause shown, or (ii) the Attorney General of the United States. Unless such party shall appear at the hearing in person or by a duly authorized representative, he shall be deemed to have consented to the issuance of an order of such removal and/or prohibition. In the event of such consent, or if upon the record made at any such hearing the Board shall find that any of the grounds specified in such notice has been established, the Board may issue such orders of suspension or removal from office, and/or prohibition from participation in the conduct of the affairs of the institution, as it may deem appropriate. Any such order shall become effective at the expiration of thirty days after service upon such institution and the association-related party (except in the case of an order issued upon consent, which shall become effective at the time specified therein). Such order shall remain effective and enforceable except to such extent as it is stayed, modified, terminated, or set aside by action of the Board or a reviewing court.

"(E) In respect to any association-related party, or any other person referred to in subparagraph (A), (B) or (C) of this paragraph, the Board may, if it deems it necessary for the protection of the association or the interests of its savings account holders, by written notice to such effect served upon such party, suspend him from office and/or prohibit him from further participation in any manner in the conduct of the affairs of the association. Such suspension and/or prohibition shall become effective upon service of such notice and, unless stayed by a court in proceedings authorized by subparagraph (F) of this paragraph, shall remain in effect pending the completion of the administrative proceedings pursuant to the notice served under subparagraph (A), (B) or (C) of this paragraph and until such time as the Board shall dismiss the charges specified in such notice, or, if an order of removal and/or prohibition is issued against the association-related party, until the effective date of any such order. Copies of any such notice shall also be served upon the association from which the suspension and/or prohibition is to be effective.

"(F) Within ten days after any association-related party has been suspended from office and/or prohibited from participation in the conduct of the affairs of an association under subparagraph (D) of this paragraph, such party may apply to the United States district court for the judicial district in which the principal office of the institution is located, or the Untied States District Court for the District of Columbia, for a stay of such suspension and/or prohibition pending the completion of the administrative proceedings pursuant to the notice served upon such association-related party under subparagraph (A), (B) or (C) of this subsection, and such court shall have jurisdiction to stay such suspension and/or prohibition.".

SUSPENSIONS AND REMOVALS BASED ON INDICTMENTS OR CONVICTIONS

SEC. 210. Section 407(h) of the National Housing Act (12 U.S.C. 1730(h) is amended to read as follows:

"(h)(1) Whenever any institution-related party is charged in any information or indictment, or any complaint authorized by a United States attorney, with the commission of or participation in a crime involving dishonesty or a breach of trust, which is punishable by imprisonment for a term exceeding one year under State or Federal law, the Corporation may, if continued service or participation by the individual may pose a threat to the interests of an insured institution's accountholders, or may threaten to impair public confidence in the insured institution, by written notice served upon such institution-related party, suspend him from office or prohibit him from further participation in any manner in the conduct of the affairs of the insured institution. A copy of such notice also shall be served upon the insured institution to which such individual is or was related. Such suspension or prohibition shall remain in effect until such information, indictment, or complaint is finally disposed of or until terminated by the Corporation. In the event that a judgment of conviction with respect to the charge is entered against such institution-related party and at such time as such judgment is not subject to further appellate review, the Corporation may, if continued service or participation by the individual may pose a threat to the interests of the insured institution's accountholders, or may threaten to impair public confidence in the insured institution, issue and serve upon such institution-related party an order removing him from office and/or prohibiting him from participation in any manner in the conduct of the affairs of the insured institution to which he is or was related, except with the consent of the Corporation. A copy of such order also shall be served upon the insured institution, whereupon such individual shall cease to be an institution-related party of such institution. A finding of not guilty or other disposition of the charge shall not preclude the Corporation from thereafter instituting proceedings to remove and/or prohibit such institution-related party pursuant to paragraph (1), (2), (3) or (4) of subsection (g) of this section. Any notice of suspension or order of removal issued under this paragraph shall remain effective and outstanding until the completion of any hearing or appeal authorized under paragraph (2) of this subsection, unless terminated by the Corporation.

"(2) Within thirty days from service of any notice of suspension or order of removal and/or prohibition issued pursuant to paragraph (1) of this subsection, the institution-related party concerned may request in writing an opportunity to appear before the Corporation to show that the continued service to or participation in the conduct of the affairs of the institution by such individual does not, or is not likely to, pose a threat to the interests of the institution's depositors or threaten to impair public confidence in the institution. Upon receipt of any such request, the Corporation shall fix a time (not more than thirty days after receipt of such request, unless extended at the request of the institution-related party) and place at which the party may appear, personally or through counsel, before one or more members of the Corporation or designated employees of the Corporation to submit written materials (or, at the discretion of the agency, oral testimony) and oral argument. Within sixty days of such hearing, the Corporation shall notify the institution-related party whether the suspension or prohibition from participation in any manner in the conduct of the affairs of the institution will be continued, terminated or otherwise modified, or whether the order removing and/or prohibiting such party will be rescinded or otherwise modified. Such notification shall contain a statement of the basis for the Corporation's decision, if adverse to the institution-related party.".

SEC. 211. Section 5(d)(5) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(5)) is amended to read as follows:

"(5)(A) Whenever any association-related party is charged in any information or indictment, or any complaint authorized by a United States attorney, with the commission of or participation in a crime involving dishonesty or a breach of trust, which is punishable by imprisonment for a term exceeding one year under State or Federal law, the Board may, if continued service or participation by the individual may pose a threat to the interests of the association's depositors or may threaten to impair public confidence in the association, by written notice served upon such party, suspend him from office or prohibit him from further participation in any manner in the conduct of the affairs of the association. A copy of such notice also shall be served upon the association. Such suspension or prohibition shall remain in effect until such information, indictment, or complaint is finally disposed of or until terminated by the Board. In the event that a judgment of conviction with respect to such crime is entered against such association-related party, and at such time as such judgment is not subject to further appellate review, the Board may, if continued service or participation by the individual may pose a threat to the interests of the association's depositors or may threaten to impair public confidence in the association, issue and serve upon such association-related party an order removing him from office and/or prohibiting him from further participation in any manner in the conduct of the affairs of the association except with the consent of the Board. A copy of such order shall also be served upon such association, whereupon such individual shall cease to be an association-related party. A finding of not guilty or other disposition of the charge shall not preclude the Board from thereafter instituting proceedings to remove and/or prohibit such institution-related party, pursuant to subparagraph (A), (B), (C) or (D) of paragraph (4). Any notice of suspension or order of removal issued under this subparagraph shall remain effective and outstanding until the completion of any hearing or appeal authorized under paragraph (C) hereof unless terminated by the Board.

"(B) If at any time, because of the suspension of one or more directors pursuant to this section, there shall be on the board of directors of an association less than a quorum of directors not so suspended, all powers and functions vested in or exercisable by such board shall vest in and be exercisable by the director or directors on the board not so suspended, until such time as there shall be a quorum of the board of directors. In the event all of the directors of an association are suspended pursuant to this section, the Board shall appoint persons to serve temporarily as directors in their place and stead pending the termination of such suspension, or until such time as those who have been suspended cease to be directors of the association and their respective successors take office.

"(C) Within thirty days from service of any notice of suspension or order of removal and/or prohibition issued pursuant to subparagraph (A), the association-related party concerned may request in writing an opportunity to appear before the Board to show that the continued service to or participation in the conduct of the affairs of the association by such individual does not, or is not likely to, pose a threat to the interests of the association's depositors or threaten to impair public confidence in the association. Upon receipt of any such request, the Board shall fix a time (not more than thirty days after receipt of such request, unless extended at the request of the association-related party) and place at which the party may appear, personally or through counsel, before one or more members of the Board or designated employees of the Board to submit written materials (or, at the discretion of the agency, oral testimony) and oral argument. Within sixty days of such hearing, the Board shall notify the association-related party whether the suspension or prohibition from participation in any manner in the conduct of the affairs of the association will be continued, terminated or otherwise modified, or whether the order removing and/or prohibiting such party will be rescinded or otherwise modified. Such notification shall contain a statement of the basis for the Board's decision, if adverse to the association-related party. The Board is authorized to prescribe such rules as may be necessary to effectuate the purposes of this subsection.".

ANCILLARY PROVISIONS: SUBPOENA POWER

SEC. 212. Section 407(m)(2) of the National Housing Act (12 U.S.C. 1730(m)(2)) is amended to read as follows:

"(2) In connection with examinations of insured institutions and affiliates thereof, the Corporation, or its designated representatives, shall have power to administer oaths and affirmations and to examine and to take and preserve testimony under oath as to any matter concerning the affairs, assets, or ownership of any such institution or affiliate thereof, or of any entity that was an insured institution or affiliate thereof at the time of the transaction or conduct being examined, and to issue subpoenas and subpoenas duces tecum. The Corporation is authorized to enforce such subpoenas by applying to the United States district court for the judicial district, or the United States court in any territory, in which the principal office of the institution or affiliate thereof is located, or in which the witness resides or carries on business, or in the District of Columbia. Such courts shall have jurisdiction and power to order and require compliance with any such subpoena, and any failure to obey such an order of the court may be punished by such court as contempt thereof. Any person who shall, without just cause, fail or refuse to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, and other records, in obedience to the subpoena of the Corporation, shall be guilty of a misdemeanor and, upon conviction, shall be subject to a fine of not more than $1000 or to imprisonment for a term of not more than one year, or both.".

PENALTIES

SEC. 213. Section 407(p) of the National Housing Act (12 U.S.C. 1730(p)) is amended to read as follows:

"(p)(1) Any person against whom there is outstanding and effective any notice or order (which is an order that has become final) served upon such person under subsections (g) or (h) of this section or under sections 1464(d)(4) or (5) of this title, or under section 1818(e) of this title, and who

"(A) participates in any manner in the conduct of the affairs of the institution from which he has been suspended, removed and/or prohibited, or directly or indirectly solicits or procures, or transfers or attempts to transfer, or votes or attempts to vote any proxies, consents, or authorizations in respect to any voting rights in such institution, or

"(B) without the prior written approval of the Corporation, votes for a director, or serves or acts as a director, officer, employee, or agent or otherwise participates in any manner in the conduct of the affairs of any institution the accounts of which are insured by the Corporation, or without the written prior approval of the appropriate federal regulatory authority, engages in said conduct with respect to any other depository institution the accounts of which are insured by the Federal Deposit Insurance Corporation or any other agency of the federal government.

"shall be guilty of a misdemeanor, and upon conviction, be fined not more than $5,000 or imprisoned for not more than one year, or both.

"(2) Except with the prior written consent of the Corporation, no person shall serve as an institution-related party who has been convicted of a criminal offense involving dishonesty or breach of trust. For each knowing violation of this prohibition, the institution involved shall be subject to a penalty of not more than $100 for each day this prohibition is violated, which the Corporation may recover by suit or otherwise for its own use.".

SEC. 214. Section 5(d)(12) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(12)) is amended to read as follows:

"(12)(A) Any person against whom there is outstanding and effective any notice or order (which is an order that has become final) served upon such person under subsections (4) or (5) of this section or under section 1730(g) or (h) of this title or under section 1818(e) of this title and who

"(i) participates in any manner in the conduct of the affairs of the association from which he has been suspended, removed and/or prohibited, or directly or indirectly solicits or procures, or transfers or attempts to transfer, or votes or attempts to vote any proxies, consents, or authorizations in respect to any voting rights in such association, or

"(ii) without the prior written approval of the Board votes for a director, or serves or acts as a director, officer, employee, or agent or otherwise participates in any manner in the conduct of the affairs of any depository institution the accounts of which are insured by the Corporation, or without the prior written approval of the appropriate federal regulatory authority, engages in such conduct with respect to any other depository institution the accounts of which are insured by the Federal Deposit Insurance Corporation or any other agency of the federal government,

"shall be guilty of a misdemeanor, and upon conviction, be fined not more than $5,000 or imprisoned for not more than one year, or both.

"(B) Except with the prior written consent of the Corporation, no person shall serve as an association-related party who has been convicted of a criminal offense involving dishonesty or breach of trust. For each knowing violation of this prohibition, the institution involved shall be subject to a penalty of not more than $100 for each day this prohibition is violated, which the Board may recover by suit or otherwise for its own use.".

DEFINITIONS

SEC. 215. Section 407(r) of the National Housing Act (12 U.S.C. 1730(r)) is amended--

(1) by adding at the end of paragraph (r)(1) thereof the following:

"(E) The term "unsafe or unsound practice" includes any action or omission, which is, in the opinion of the Corporation, contrary to generally accepted standards of prudent operation, whether relating to the institution's internal management or to any external matter, the possible consequence of which, if continued, may be abnormal risk or loss or damage to an insured institution or any subsidiary thereof, to its stockholders or account holders, or to the Corporation; and

"(F) The term "institution-related party" means any director, officer, employee, agent, or other person participating in the conduct of the affairs of an insured institution, or of any service corporation or any subsidiary of a service corporation of an insured institution, whether wholly or partly owned, or of any savings and loan holding company or any subsidiary of a savings and loan holding company as those terms are defined in section 1730a of this title, and any person who, with respect to a particular insured institution has filed or who is required to file a change in control notice with the Corporation pursuant to subsection (q) of this section. The status of any person as an "institution-related party" shall not be affected by the resignation, termination of employment, or other separation of such person from an insured institution."; and

(2) by adding at the end thereof the following:

"(5) As used in subsections (e), (f), (g), and (h) of this section, the term "insured institution" means any institution the deposits of which are insured by the Corporation, any institution that retains deposits insured by the Corporation notwithstanding the termination of its status as an insured institution pursuant to this section, and a Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation.".

SEC. 216. Section 5(d)(13) of the Home Owners' Loan Act (12 U.S.C. 1464(d)(13)) is amended--

(1) by adding at the end of subparagraph (A) thereof the following:

"(5) The term "unsafe or unsound practice" includes any action or omission, which is, in the opinion of the Board, contrary to generally accepted standards of prudent operation, whether relating to the association's internal management or to any external matter, the possible consequence of which, if continued, may be abnormal risk or loss or damage to an association or any subsidiary thereof, to its stockholders or account holders, or to the Federal Savings and Loan Insurance Corporation.

"(6) The term "association-related party" means any director, officer, employee, agent, or other person participating in the conduct of the affairs of an association, or of any service corporation or any subsidiary of a service corporation of an association, or of any savings and loan holding company as those terms are defined in section 1730a of this title, and any person who, with respect to a particular association, has filed or who is required to file a change in control notice with the Federal Savings and Loan Insurance Corporation pursuant to subsection (q) of section 1730 of this title. The status of any person as an "association-related party" shall not be affected by the resignation, termination of employment, or other separation of such person from an association."; and

(2) by adding at the end thereof the following:

"(C) As used in subsections (d)(2), (3), (4) and (5) of this section, the term "association" includes any former association that retains deposits insured by the Federal Savings and Loan Insurance Corporation notwithstanding the termination of its status as an institution insured by such corporation, any Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation, and any former federal savings bank that retains deposits insured by the Federal Deposit Insurance Corporation notwithstanding the termination of its status as an insured bank.".

SEC. 217. Section 407 of the National Housing Act (12 U.S.C. 1730), as amended by this Act, is amended by adding at the end thereof a new subsection (s) as follows:

"(s) The Corporation shall have the power and authority to apply for injunctive relief in the appropriate United States district court whenever it determines that the enforcement provisions of this section are insufficient to resolve adequately unsafe or unsound practices or violations or threatened violations of any of the provisions of this title or of any regulations promulgated thereunder that are applicable to insured institutions or institution-related parties.".

SEC. 218. Section 5(d) of the Home Owners' Loan Act (12 U.S.C. 1464(d)), as amended by this Act, is amended by adding at the end thereof a new paragraph (16) as follows:

"(16) The Board shall have the power and authority to apply for injunctive relief in the appropriate United States district court whenever it determines that the enforcement provisions of this section are insufficient to resolve adequately unsafe or unsound practices or violations or threatened violations of any of the provisions of this title or of any regulations promulgated thereunder that are applicable to associations or association-related parties.".

TITLE III--PAYMENT OF INSURANCE

SEC. 301. This title may be cited as the "Insurance Amendments of 1985".

SEC. 302. Section 405(b) of the National Housing Act (12 U.S.C. 1728(b)) is amended by striking out "which is surrendered and transferred to the Corporation" from the first sentence thereof, and by adding at the end thereof the following:

"Notwithstanding any other provision of law, the Corporation, upon payment of insurance as provided in this subsection (b), shall be subrogated to all rights of the insured member to the extent of such payment.".

SEC. 303. Section 405 of the National Housing Act (12 U.S.C. 1728), as amended by section 302 of this Act, is amended by adding at the end thereof the following new subsection:

"(e) Notwithstanding any other provision of law, the Corporation may withhold payment of such portion of the insured deposit of any depositor in an institution in default as may be required to provide for the payment of any liability, which is due and unpaid and is determined on the date of default, (i) of such depositor as a stockholder of the institution, or (ii) of such depositor to the institution or its receiver, pending the determination and payment of such liability by such depositor or any other person liable therefor: Provided, That such liability does not include the liability of a borrower under a note or other obligation not in default on the date of default of the institution.".

SEC. 304. Section 406(b) of the National Housing Act (12 U.S.C. 1729(b)) is amended:

(1) by striking out the last sentence of paragraph (2) and inserting in lieu thereof the following:

"Notwithstanding any other provision of law, such payment of insurance by the Corporation shall subrogate the Corporation with respect to such insured account to the extent of such payment, but shall not affect any right which an insured member may have with respect to the uninsured portion of the member's account, if any, or any right which such insured member may have to participate in the distribution of the net proceeds remaining from the disposition of the assets of such association."; and

(2) by amending paragraph (3) thereof as follows:

"(3) As used in this section, the term "Federal association" means a Federal savings and loan association or a Federal savings bank, the accounts of which are insured by the Corporation.".

TITLE IV--RECEIVERSHIP POWERS, AUTOMATIC STAY, AND PRIORITIES

SEC. 401. This title may be cited as the "Receivership Improvement Act of 1985".

SEC. 402. Section 406(d) of the National Housing Act (12 U.S.C. 1729(d)) is amended by adding at the end thereof the following:

"Notwithstanding any other provision of law, in implementing the first sentence of this subsection (d), the Corporation as conservator, receiver or legal custodian shall not be required to furnish bond for any purpose and may employ such officers, agents, attorneys, and employees as deemed necessary or appropriate by the conservator, receiver, or legal custodian, and such persons shall be employees of the conservator, receiver, or legal custodian and not of the United States, and all fees, compensation, and expenses of liquidation and administration thereof shall be fixed by the Corporation and may be paid by the Corporation out of assets coming into its possession as conservator, receiver, or legal custodian.".

SEC. 403. Section 406 of the National Housing Act (12 U.S.C. 1729), as amended by Section 304 of this Act, is further amended by adding at the end thereof the following new subsections:

"(g) No agreement, which tends to diminish or defeat the right, title, or interest of the Corporation as conservator, receiver or other legal custodian of an insured institution in any asset acquired in its capacity as such conservator, receiver or legal custodian, or acquired by the Corporation under subsection (f) of this section, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the institution and the person or persons claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the institution, (3) shall have been approved as to the transaction or type of transaction by the board of directors of the insured institution or its loan committee, and (4) shall have been, continuously, from the time of its execution, an official record of the insured institution.

"(h) Any property, wherever located, in which an insured institution, as of the appointment of receiver, has a legal or equitable interest, is property of the receivership estate, and any other party to which the receiver transfers such property shall receive such title as the receiver itself possesses.

"(i)(1) The appointment of a receiver by the Board for an insured institution pursuant to section 5(d)(6)(A) of the Home Owners' Loan Act of 1933 or section 406 of the National Housing Act operates as a stay, applicable to all entities, of:

"(A) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the receiver or insured institution, other than the filing and prosecution of a claim with the receiver and any appeal therefrom to the Board, that was or could have been commenced before the commencement of the receivership or that seeks to recover a claim against the insured institution that arose before the commencement of the receivership;

"(B) the enforcement, against the receiver or insured institution or any property of the receivership estate, of a judgment obtained before the commencement of the receivership;

"(C) any act to obtain possession of property of the receivership estate or from the receivership estate;

"(D) any act to create, perfect, or enforce any lien against property of the estate or to exercise control over property of the estate;

"(E) any act to create, perfect, or enforce against property of the receivership estate any lien to the extent that such lien secures a claim that arose before the commencement of the receivership;

"(F) any act to collect, assess, or recover a claim against the receiver or insured institution that arose before the commencement of the receivership;

"(G) the setoff of any debt owing to the insured institution that arose before the commencement of the receivership against any claim against the receiver or insured institution; and

"(H) the commencement or continuation of a proceeding before the United States Tax Court concerning the insured institution.

"(2) The appointment of the Corporation as receiver does not operate as a stay of--

"(A) the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power;

"(B) the enforcement of a judgment, other than a money judgment, obtained in an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power;

"(C) a setoff that constitutes the setoff of a claim against the insured institution for a "margin payment" as defined in 11 U.S.C. 741(5) or "settlement payment", as defined in 11 U.S.C. 741(8), arising out of a "securities contract", as defined in 11 U.S.C. 741(7);

"(D) the exercise of a contractual right by a "repo participant", as defined in 11 U.S.C. 101, (i) to cause the liquidation of a repurchase agreement or (ii) to set off any mutual debt and claim under or in connection with a repurchase agreement that constitutes a setoff of a claim against the insured institution for a margin payment or settlement payment as defined in subparagraph (C) above: Provided, That any liquidation of a repurchase agreement shall be accomplished in a commercially reasonable manner and any excess received by a repo participant over the stated repurchase price, including interest, if any, and reasonable cost of liquidation, shall be paid to the receiver;

"(E) the commencement of any action by the Secretary of the Department of Housing and Urban Development to foreclose a mortgage or deed of trust in any case in which the mortgage or deed of trust held by said Secretary is insured or was formerly insured under the National Housing Act and covers property, or combinations of property, consisting of five or more living units;

"(F) the issuance to the insured institution by a governmental unit of a notice of tax deficiency.

"(G) an act by a lessor to the insured institution under a lease of nonresidential real property that has terminated by the expiration of the stated term of the lease before the appointment of the receiver or during the receivership; or

"(H) the presentment of a negotiable instrument and the giving of notice of and protesting dishonor of such an instrument.

"(3) Except as provided in subparagraphs (4) and (5) of this subsection the stay of an act against property of the estate under paragraph (1) of this section continues until such property is no longer property of the estate and the stay of any other act continues until the termination of the receivership.

"(4) On request of a party in interest the Board shall grant relief from the stay provided under paragraph (1) of this subsection, such as by terminating, annulling, modifying, or conditioning such stay--

"(A) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

"(B) with respect to a stay of an act against property, if--

"(i) the insured institution does not have an equity interest in such property; and

"(ii) such property is not necessary to an effective reorganization.

"(5) Thirty days after a request under subparagraph (4) of this subsection for relief from the stay of any act against property of the estate under paragraph (1) of this subsection, such stay is terminated with respect to the party in interest making such request, unless the Board orders such stay be continued in effect pending, or as a result of, a final determination under subparagraph (4) of this subsection. The Board shall grant such relief from any stay provided under this subsection (h) as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is a final determination under subparagraph (4) of this subsection.

"(6) Notwithstanding any other provision of this subsection, the appointment of a receiver by the Board for an insured institution pursuant to section 5(d)(6)(A) of the Home Owners' Loan Act of 1933 or section 406 of the National Housing Act does not operate as a stay of any act by a Federal Home Loan Bank or its assignee to enforce a security interest in favor of a Federal Home Loan Bank or its assignee against the property of an insured institution or any affiliate thereof, which lien secures an obligation of the institution to the Federal Home Loan Bank if:

"(A) said lien has been obtained in compliance with regulations promulgated by the Board or the Corporation with respect to the collateralization of Bank advances; and

(B) said security interest constitutes a valid security interest under the laws of the state in which the principal office of the insured institution is located.

"(7) Notwithstanding any other provision herein, or any other provision of law, state or Federal, or the constitution of any state, no security interest of a Federal Home Loan Bank or its assignee in property of an insured institution or any affiliate thereof shall be enjoined from enforcement, avoided, subordinated, or otherwise impaired because it was perfected subsequent to the making of the advance that it secures, because it was not perfected, or because of the exercise or performance by the Bank or any officer or employee thereof of a function of the Board or the Corporation, including any supervisory or regulatory function, authorized or assigned by the Board or the Corporation; such security interest of a Federal Home Loan Bank or its assignee shall be deemed a valid, enforceable, perfected secured claim having priority with respect to such property over all claims other than a claim secured by a valid security interest in such property that was perfected prior to such time, if any, as the security interest of the Federal Home Loan Bank was perfected; and in the event that such prior perfected security interest exists, the security interest of the Federal Home Loan Bank or its assignee shall be subordinate only to that of such lien creditor in the specific property that is the subject of dispute.

"(8) Any disposition by a Federal Home Loan Bank or its assignee of collateral securing an advance shall be effected in a commercially reasonable manner.

"(j) When adequate protection is required under subsection (i) of an interest of an entity in property, such adequate protection may be provided by--

"(1) the receiver's agreement to make periodic cash payments to such entity, to the extent that the stay under subsection (j) results in a decrease in the value of such entity's interest in such property;

"(2) the receiver's providing to such entity an additional or replacement lien to the extent that such results in a decrease in the value of such entity's interest in such property; or

"(3) the receiver's granting such other relief, as an administrative expense, as will result in the realization by such entity of the equivalent of such entity's interest in such property.".

"(k)(1) A receiver appointed by the Board for an insured institution pursuant to section 5(d)(6)(A) of the Home Owners' Loan Act of 1933 or section 406 of the National Housing Act shall have the rights and powers of, or may avoid any transfer of property of the insured institution or any obligation incurred by the insured institution that is voidable by

"(A) a creditor that extends credit to the insured institution immediately prior to the appointment of the receiver, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor or lien exists;

"(B) a creditor that extends credit to the insured institution, immediately prior to the appointment of the receiver and obtains, at such time and with respect to such credit, an execution against the insured institution that is returned unsatisfied at such time, whether or not such a creditor exists;

"(C) a bona fide purchaser of real property other than fixtures from the insured institution, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer immediately prior to the appointment of the receiver, whether or not such a purchaser exists; or

"(D) an equity receiver.

"(2) The receiver may avoid any transfer of an interest of the insured institution in property or any obligation incurred by the insured institution that is voidable under applicable law by a creditor holding an unsecured claim that is allowable by the receiver.

"(3) The receiver may avoid the fixing of a statutory lien on property of insured institutions to the extent that such lien--

"(A) first becomes effective against the insured institution:

"(i) when an insolvency proceeding other than under this title concerning the insured institution is commenced;

"(ii) when a custodian, conservator, or receiver is appointed or authorized to take or takes possession of the insured institution;

"(iii) when the insured institution becomes insolvent;

"(iv) when the insured institution's financial condition fails to meet a specified standard; or "(v) at the time of an execution against property of the insured institution levied at the instance of an entity other than the holder of such statutory lien;

"(B) is not perfected or enforceable against a bona fide purchaser that purchases such property immediately prior to the appointment of the receiver, whether or not such a purchaser exists;

"(C) is for rent; or

"(D) is a lien of distress for rent.

"(4) The receiver may avoid anv transfer of an interest of the insured institution in property or any obligation incurred by the insured institution that was made or incurred, voluntarily or involuntarily, with actual intent to hinder, delay, or defraud any entity to which the insured institution was or became, on or after the date that such transfer was made or such obligation was incurred, indebted.

"(1) Notwithstanding any other provision of law, State or Federal, or the constitution of any State, in connection with the liquidation of insured institutions in default, the Corporation as receiver shall make provision for payment of unsecured claims against the estate of the institution in default proved to the satisfaction of the receiver or the Board in the following order:

"(1) Administrative expenses of the receiver, including the costs, ~~expenses~~, and debts of the Receiver;

"(2) Administrative expenses of the insured institution: Provided, That such expenses were incurred within thirty (30) days prior to the receiver's taking possession, and that such expenses shall be limited to reasonable expenses incurred for services actually provided by accountants, attorneys, appraisers, or examiners that, in the opinion of the receiver, are of benefit to the receivership estate, and shall not include wages or salaries of employees of the Association;

"(3) Claims for wages and salaries, including vacation, sick leave pay, and contributions to employee benefit plans earned by an employee of the insured institution within thirtv (30) days prior to the appointment of the receiver up to a maximum of two thousand dollars ($2,000) per person;

"(4) Claims of governmental units for unpaid taxes; but no other claim of a governmental unit shall have a priority higher than that of the fifth category below;

"(5) Claims for withdrawable accounts, including those of the Corporation as subrogee or transferee, and all other claims, whether liquidated or unliquidated, which have accrued and become unconditionally fixed on or before the date of default, except as provided below in the succeeding paragraphs of this subsection;

"(6) Claims other than those that have accrued and become unconditionally fixed on or before the date of default, including claims for interest after the date of default on claims of the fifth category; and any claim based on an agreement for accelerated, stipulated, or liquidated damages, which claim did not accrue prior to the date of the default, shall be considered as not having accrued and become unconditionally fixed on or before the date of default;

"(7) Claims that have been subordinated in whole or in part to general creditor claims, which shall be given the priority specified in the written instruments that evidence such claims;

"(8) Claims by holders of nonwithdrawable accounts, including stock, which shall have priority within this eighth category in accordance with the terms of the written instruments that evidence such claims.

"(m) Interest after the date of default on claims of the fifth category of subsection (l) shall be at a rate or rates adjusted monthly to reflect the average rate for U.S. Treasury bills with maturities of not more than ninety-one (91) days during the preceding three (3) months.

"(n) All unsecured claims of any category of priority described in (l)(1) through (l)(8) above shall be paid in full, or provision made for such payment, before any claims of lesser priority are paid; if there are insufficient funds to pay any class of claims of one priority in full, distribution to claimants in such class shall be made pro rata; and notwithstanding anything to the contrary herein, the receiver may at any time, and from time to time, prior to the payment in full of all claims of a class having higher priority, make such ratable distributions to claimants in priority classes (l)(1), (2), (3), (4), and (5) as the receiver believes are reasonably necessary to conduct the receivership: *Provided*, That the receiver determines that adequate funds exist or will be recovered during the receivership to pay in full all claims of any higher priority.

SEC. 404. Section 5(d)(6)(D) of the Home Owners' Loan Act (12 U.S.C. 1464 (d)(6)(D)) is amended by striking the second and third sentences and inserting in lieu thereof the following:

"The Board shall appoint, except as hereafter provided, only the Federal Savings and Loan Insurance Corporation as conservator or receiver for an association, and said Corporation shall have power to buy at its own sale as conservator or receiver, subject to approval by the Board. The Board may, without any requirement of notice, hearing, or other action, replace a conservator with a receiver, but any such replacement shall not affect any right which the association may have to obtain judicial review of the original appointment, except that any removal under this paragraph shall be removal of the conservator or receiver in office at the time of such removal.

TITLE V--FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

SEC. 501. This title may be cited as the "Federal Savings and Loan Insurance Corporation Improvements Act of 1985".

SEC. 502. Section 9101 of title 31, United States Code, is amended--

(1) in paragraph (2) by redesignating subparagraphs (G) through (J) as (H) through (K), respectively, and by adding a new subparagraph as follows: "(G) the Federal Savings and Loan Insurance Corporation."; and

(2) in paragraph (3) by striking out subparagraph (E) and by redesignating subparagraphs (F) through (M) as (E) through (L), respectively.

SEC. 503. Section 402(c) of the National Housing Act (12 U.S.C. 1725(c)) is amended--

(1) by striking out the period at the end of the fourth sentence of paragraph (5) thereof and by inserting in lieu thereof the following: ", as now in effect or hereafter enacted, including without limitation any restriction, statutory or otherwise, relating to personnel, personnel employment levels, or apportionment of.expenses."; and

(2) by adding a new paragraph (6) at the end thereof as follows:

"(6) To issue such rules, regulations and orders as it deems necessary or appropriate to define the terms used in this Act which for purposes of this paragraph, includes, without limitation, the provisions of sections 407(q) and 408; to enable it to administer and carry out the purposes of this Act, including, but not limited to the regulation of risk-taking by insured institutions; and to require compliance therewith and prevent evasions thereof.".

SEC. 504. Section 406 of the National Housing Act (12 U.S.C. 1729) as amended by this Act, is amended by adding at the end thereof the following new subsection:

(p) Expenditures of the Corporation to carry out the purposes of this Act shall not be or be deemed to be from or of appropriations, appropriated amounts, appropriated funds, or funds for purposes of title 31, United States Code, or any other provision of law.".

SEC. 505. Section 404 of the National Housing Act (12 U.S.C. 1727), as amended by this Act, is further amended by adding at the end thereof the following new subsection:

"(j) Except as provided in this section, no funds of any insured institution paid to or on deposit with the Corporation shall be subject to attachment, garnishment, or other legal process by creditors of any insured institution.".

SEC. 506. Section 407(k)(1) of the National Housing Act (12 U.S.C. 1730(k)(1)) is amended by inserting immediately after the words "state-chartered institution" in the first sentence thereof the phrase "pursuant to an appointment by State authorities".

TITLE VI--HOLDING COMPANIES

SEC. 601. This title may be cited as the "Holding Company Amendments of 1985".

SEC. 602. Section 408(c) of the National Housing Act (12 U.S.C. 1730a(c)) is amended:

(1) by inserting "(1)" immediately after the initial "(c)";

(2) by redesignating paragraphs (1) and (2) as (A) and (B) respectively; and

(3) by adding the following new paragraph at the end thereof:

"(2) Notwithstanding any other provision of law, no savings and loan holding company, or insured institution, directly or indirectly, or through one or more subsidiaries or one or more transactions, shall be engaged in the activities of an underwriter or of a market-maker in (i) equity securities, or (ii) debt securities other than those secured by interests in real estate or that are eligible to be underwritten by national banks.".

PROHIBITED TRANSACTIONS

SEC. 603. Section 408(d) of the National Housing Act (12 U.S.C. 1730a(d)) is amended by inserting in the first sentence thereof after "insured institution" the following: "or subsidiary thereof," and by inserting in subparagraph (1) thereof after "as authorized by law" the following: "in the case of investment by the insured institution, or other than the parent insured institution, in the case of investment by its subsidiary".

SEC. 604. Sections 408(d)(4) and (5) of the National Housing Act (12 U.S.C. 1730a (d)(4) and (5)) are amended to read as follows:

"(4) make any loan, discount, extension of credit to (A) any affiliate, other than an insured institution's service corporation subsidiary or a joint venture in which an insured institution's service corporation subsidiary is a general partner, provided that the other partners and other parties with an interest in the joint venture are not affiliates of the insured institution, except in a transaction authorized by subparagraph (A) of paragraph (6) of this subsection, or (B) any third party on the security of any property acquired from any affiliate, or with knowledge that the proceeds of any such loan, discount, or extension of credit, or any part thereof, are to be paid over to or utilized for the benefit of any affiliate: Provided, however, that a subsidiary insured institution, or subsidiary thereof, may make a loan, discount, or extension of credit to a third party on the security of property acquired from its service corporation, provided that no other affiliate has a direct or indirect interest in that service corporation other than through the subsidiary insured institution.

"(5) guarantee the repayment of or maintain any compensating balances for any loan or extension of credit granted to any affiliate (other than a wholly-owned service corporation) by any third party.".

SEC. 605. Section 408(e)(3) of the National Housing Act (12 U.S.C. 1730a(e)(3)) is amended--

(1) by striking out "or" in subparagraph (A); and

(2) by striking out the period in subparagraph (B) and inserting in lieu thereof a semicolon;

(3) by adding at the end thereof the following new subparagraphs:

"(C) result in a savings and loan holding company which is itself an uninsured institution, or which directly or indirectly has control of an uninsured institution; however, the Corporation may in its sole discretion, permit operation as, or control of, an uninsured institution to be acquired and/or retained for up to one year after control has been acquired of the insured institution or uninsured institution, whichever is later, if the Corporation specifically determines that such an extension would not represent an undue risk to the Corporation's insurance fund, or for a longer period if the Corporation specifically determines that such an extension beyond one year, including in perpetuity, assists the Corporation in preserving the Corporation's insurance fund or that such an extension would not represent an undue risk to such fund; or

"(D) result in the acquisition directly or indirectly, or through one or more transactions, of an insured institution by a company engaged in the activities of an underwriter of or market-maker in equity or debt securities, as defined by the Corporation, other than those representing interests in real estate or that are eligible to be underwritten by national banks.".

SEC. 606. Section 408(h) of the National Housing Act (12 U.S.C. 1730a(h)) is amended-

(1) by deleting paragraph (1) thereof; and

(2) by redesignating paragraphs (2) through (6) as (1) through (5) respectively.

SEC. 607. Section 408(h)(3) of the National Housing Act (12 U.S.C. 1730a(h)(4)), as amended and redesignated, is amended by striking out all that follows "to enforce compliance with this section or any rule, regulation or order thereunder," and inserting in lieu thereof the following:

"and for such other relief as may be appropriate, including but not limited to the divestiture of any acquisition made in violation of this section, rescission of transactions effected in violation of this section, or restitution to persons suffering damage as a result of violations of this section. Upon proper showing, an injunction, decree, restraining order, order of divestiture, rescission, restitution or other appropriate order shall be granted. No bond shall be required of the Corporation.".

SEC. 608. Section 408(m)(1)(B)(i) of the National Housing Act (12 U.S.C. 1730a(m)(1)(B)(i)) is amended to read as follows:

"(B)(i) Before making a determination to take any action under subparagraph (A) with respect to the merger or acquisition of a state-chartered institution, the Corporation shall consult the State supervisor having principal jurisdiction of such acquired institution.".

TITLE VII--QUALIFIED THRIFT LENDERS

SEC. 701. This title may be cited as the "Qualified Thrift Lender Act of 1985".

INSURANCE ELIGIBILITY

SEC. 702. Section 403(a) of the National Housing Act (12 U.S.C. 1726(a)) is amended--

(1) by inserting in paragraph (2) after "accounts of" the following: "any institution which is a qualified thrift lender, as defined in paragraph (3) of this subsection, including"; and

(2) by adding at the end thereof the following:

"(3)(A) Except as provided in subparagraph (B) of this paragraph, a qualified thrift lender is an institution that, as determined by the Corporation, has an aggregate of not less than 60 percent of its assets (including investments made by any subsidiary of such an institution) invested in:

"(i) cash,

"(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof,

"(iii) liquid assets of the type required to be maintained pursuant to regulations issued by the Federal Home Loan Bank Board under section 5A of the Federal Home Loan Bank Act,

"(iv) certificates of deposit in, or obligations of, a corporation organized under a state law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

"(v) loans secured by a deposit or share of a member,

"(vi) loans, equity positions, or securities related to domestic residential real property, manufactured housing, or real property used primarily for church purposes, including loans to facilitate the construction, improvement or equipping of domestic residential real property, manufactured housing, multi-family dwellings, property used primarily for church purposes, and shelter-providing facilities as set forth in subdivision (viii) hereof,

"(vii) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property, "(viii) loans secured by an interest in educational, health, or welfare institutions or facilities, including shelter providing facilities for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

"(ix) loans made for the payment of expenses of college or university education or vocational training,

"(x) property acquired through the liquidation of defaulted loans described in clauses (vi), (vii) or (viii),

"(xi) property used by an institution in the conduct of its business:

"Provided, That such institution does not thereafter fall below such percentage on an average basis in three out of every four quarters in three out of every five years; "Provided further, That the 60% requirement shall be reduced for any averaging period by the amount of loans relating to domestic residential real property or manufactured housing, originated and sold during such period by such institution or any subsidiary thereof, by such a percentage as the Corporation may determine appropropriate.

"(B) For a twenty year period following the date of enactment of this paragraph, "qualified thrift lender" shall also include an institution chartered as a mutual savings bank under state law, provided that the Corporation determines that--

"(i) the institution has an aggregate of not less than 50 percent of its assets (including investments made by any subsidiary of such an institution) invested in assets of the type set forth in subparagraph (A) of this paragraph, and

"(ii) the institution does not decrease the percentage of its assets invested in accordance with subparagraph (A) of this paragraph below the percentage it held on the date of enactment of this paragraph, and increases such percentage of its assets invested in accordance with said subparagraph (A) by an amount at least equal to the following percentages of the difference between 60 per centum and the percentage of its assets invested in accordance with said subparagraph (A) on the date of enactment of this paragraph within the following time periods from the date of enactment of this paragraph:

"(I) within five years, 25 per centum;

"(II) within ten years, 50 per centum;

"(III) within fifteen years, 75 per centum."

"(C) Any institution that fails to maintain its status as a qualified thrift lender, as determined by the Corporation, may not thereafter be a qualified thrift lender for a period of five years.

"(D) The Corporation may conduct examinations, to carry out the provisions of this paragraph: Provided, That with respect to a federal stock savings bank insured by the Federal Deposit Insurance Corporation, the Corporation shall rely to the maximum extent possible on examinations conducted by that agency.".

ELIGIBILITY FOR ADVANCES

SEC. 703. Section 10 of the Federal Home Loan Bank Act (12 U.S.C. 1430) is amended by adding at the end thereof the following new subsection:

"(e) Except as the Board may prescribe, no member, the deposits of which are insured by the Federal Savings and Loan Insurance Corporation or the Federal Deposit Insurance Corporation, shall be eligible for advances unless such member is a qualified thrift lender as defined in section 403(a)(3) of the National Housing Act.".

INVESTMENT AUTHORITY

SEC. 704. Section 5(c)(4)(B) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(c)(4)(B)) is amended by striking the remainder of the sentence after "except that" and inserting in lieu thereof the following: "the limitation contained herein shall be five per centum of the assets of an association which is a qualified thrift lender as defined in section 403(a)(3) of the National Housing Act.".

BRANCHING

SEC. 705. Section 5(r)(1) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(r)(1)) is amended--

(1) by striking out in the first sentence "domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954 or meets the asset composition test imposed by subparagraph (c) of that section on institutions seeking so to qualify." and inserting in lieu thereof the following: "qualified thrift lender as defined in section 403(a)(3) of the National Housing Act."; and

(2) by striking out in the second sentence "domestic building and loan association under said section 7701(a)(19)." and inserting in lieu thereof the following: "qualified thrift lender as defined in said section 403(a)(3).".

EMERGENCY THRIFT ACQUISITIONS

SEC. 706. Section 408(m)(5)(C)(i) of the National Housing Act (12 U.S.C. 1730a(m)(5)(C)(i)) is amended by striking out "domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954 or does not meet the asset composition test imposed by subparagraph (c) of that section on institutions seeking so to qualify," and inserting in lieu thereof the following: "qualified thrift lender as defined in section 403(a)(3) of this Act,".

UNITARY ACTIVITIES

SEC. 707. Section 408(n) of the National Housing Act (12 U.S.C. 1730a(n)) is amended by striking out "domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954," and inserting in lieu thereof the following: "qualified thrift lender as defined in section 403(a)(3) of this Act,".

TITLE VIII--MISCELLANEOUS

FEDERAL HOME LOAN BANK BOARD; CREATION, ETC.

SEC. 801. Section 17 of the Federal Home Loan Bank Act (12 U.S.C. 1437) is amended by adding at the end thereof the following new subsection:

"(c) Notwithstanding any other provision of law, in accordance with board regulations to prevent conflicts of interest, the board may accept payment and reimbursement, in cash or in kind, from Federal or non-Federal agencies, organizations (including industry trade groups), and individuals for travel, subsistence, and other necessary expenses incurred by board members and employees in attending meetings and conferences concerning the functions or activities of the board. Any payment or reimbursement accepted shall be deposited in the Treasury of the United States, and from time to time may be withdrawn therefrom to defray such expenses. The amount of travel, subsistence, and other necessary expenses for members and employees paid or reimbursed under this subsection may exceed per diem amounts established in official travel regulations, but the board may limit such amounts. For the purposes of this subsection, "board" shall include the Federal Savings and Loan Insurance Corporation: Provided, That payments or reimbursements received by such Corporation shall be deposited pursuant to chapter 31 of title 31.".

DEMAND ACCOUNTS

SEC. 802. Section 5(b)(1) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(b)(1)) is amended--

(1) by amending subparagraph (A) to read as follows:

"(A) An association may raise capital in the form of such deposits, shares, or other accounts (all of which are referred to in this section as accounts) as are authorized by its charter or by regulations of the Board, and may issue such passbooks, certificates, or other evidence of accounts as are so authorized."; and

(2) by striking out the first and second sentences of subparagraph (B).

SEC. 803. Section 1832(a)(1) of Title 12, United States Code, is amended to read as follows:

"(1) Notwithstanding any other provision of law, a depository institution is authorized to permit the owner of a deposit or account on which interest or dividends are paid to make withdrawals by negotiable or transferable instruments for the purpose of making transfers to third parties.".

SEC. 804. Section 19 of the Federal Home Loan Bank Act (12 U.S.C. 1439) is amended by adding at the end thereof the following:

"Notwithstanding any other provision of law, former employers of participants in the Board's professional accounting fellows programs may pay such participants their actual expenses for relocation to Washington, District of Columbia, to facilitate their participation in such programs, and program participants may accept such payments.".

SEC. 805. The Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, is amended as follows:

(1) in section 141 by striking "three" and inserting in lieu thereof "six"; and

(2) in section 206 by striking "three" and inserting in lieu thereof "six".

SEC. 806. The National Housing Act and the Federal Deposit Insurance Act are amended as follows:

(1) section 403 of the National Housing Act (12 U.S.C. 1726), as amended by this Act, is further amended by adding at the end thereof the following new subsection:

"(c) If, upon application, and pursuant to a plan of conversion to an institution of a type eligible to be an insured institution, the Corporation, in its discretion, determines to grant insurance of accounts to a savings bank that is an insured bank (as the term 'insured bank' is defined in section 3(h) of the Federal Deposit Insurance Act), such insurance shall become effective at such time as the Corporation stipulates, at which time such institution automatically shall lose its status as such an insured bank. No change of deposit insurance agencies from the Federal Deposit Insurance Corporation to the Corporation shall be treated, for the purposes of section 18(i) of the Federal Deposit Insurance Act, as involving a conversion to a noninsured bank or institution, except that the Corporation shall provide the Federal Deposit Insurance Corporation with notification of any application that, if granted, would involve such a change of deposit insurance agencies, shall consult with the Federal Deposit Insurance Corporation before disposing of the application, and shall provide the Federal Deposit Insurance Corporation with notification of the determination with respect to such application."; and

(2) section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended:

(A) by amending paragraph (c)(12) thereof to read as follows:

"(12) The provisions of this subsection shall not apply to any transaction where the acquiring, assuming or resulting institution is an insured Federal savings bank or an institution insured by the Federal Savings and Loan Insurance Corporation, except that any insured bank involved in the transaction shall notify the Corporation in writing at least 30 days prior to consummation of the transaction and, if any approval by the Federal Home Loan Bank Board or the Federal Savings and Loan Insurance Corporation is required in connection therewith, such approving authority shall provide the Corporation with notification of the application for approval, shall consult with the Corporation before disposing of the application, and shall provide notification to the Corporation of the determination with respect to said application."; and

(B) by adding at the end of subsection (i) thereof the following new paragraph:

"(5) Nothing in this subsection shall apply to a conversion of an insured bank to an insured institution pursuant to section 403(a) of the National Housing Act (12 U.S.C. 1726(a))."

SEC. 807. The first sentence of section 7(d) of the Federal Home Loan Bank Act (12 U.S.C. 1427(d)) is amended by inserting before the period at the end thereof the following:

"Provided, that the Board is authorized to increase or decrease the terms of directors of each bank to provide for staggered terms for such directors".

SEC. 808. Section 407(q)(8)(B) of the National Housing Act (12 U.S.C. 1730(q)(8)(B) is amended to read as follows:

FERNAND J. ST GERMAIN, RHODE ISLAND, CHAIRMAN
HENRY B. GONZALEZ, TEXAS
FRANK ANNUNZIO, ILLINOIS
PARREN J. MITCHELL, MARYLAND
WALTER E. FAUNTROY, DISTRICT OF COLUMBIA
STEPHEN L. NEAL, NORTH CAROLINA
CARROLL HUBBARD, JR., KENTUCKY
JOHN J. LaFALCE, NEW YORK
STAN LUNDINE, NEW YORK
MARY ROSE OAKAR, OHIO
BRUCE F. VENTO, MINNESOTA
DOUG BARNARD, JR., GEORGIA
ROBERT GARCIA, NEW YORK
CHARLES E. SCHUMER, NEW YORK
BARNEY FRANK, MASSACHUSETTS
BUDDY ROEMER, LOUISIANA
RICHARD H. LEHMAN, CALIFORNIA
BRUCE A. MORRISON, CONNECTICUT
JIM COOPER, TENNESSEE
MARCY KAPTUR, OHIO
BEN ERDREICH, ALABAMA
SANDER M. LEVIN, MICHIGAN
THOMAS R. CARPER, DELAWARE
ESTEBAN E. TORRES, CALIFORNIA
GERALD D. KLECZKA, WISCONSIN
BILL NELSON, FLORIDA
PAUL E. KANJORSKI, PENNSYLVANIA
BART GORDON, TENNESSEE
THOMAS J. MANTON, NEW YORK
JAIME B. FUSTER, PUERTO RICO

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
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October 16, 1985

CHALMERS P. WYLIE, OHIO
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TO: Members, Subcommittee on Financial Institutions Supervision, Regulation and Insurance

FROM: Committee Staff

SUBJECT: FHLBB Proposal: "Thrift Regulatory Improvements Act of 1985"

The following is a section-by-section analysis of the FHLBB proposal prepared jointly by the Majority and Minority committee staff.

Section 101 - Short Title: "Insured Accounts Improvement Act"

Section 102 - Under current law, the FHLBB may require insured institutions to make deposits into the FSLIC, up to an amount equal to 1% of total deposits. While there is no requirement that the FSLIC repay these deposits, until they are repaid they are carried as a debt by the insurance agency. Further, while the statute leaves the call and use of such deposits totally within the discrection of the FHLBB, the Senate report associated with this provision states that it is intended to meet shortrun liquidity problems, and not to build up the adequacy of the reserve fund.

This section of the bill amends current law to provide that the FHLBB may require insured institutions to deposit up to 1% of total deposits into the FSLIC, which may be used to meet FSLIC expenses. These deposits are to be considered assets of the insured institution and reserves of the FSLIC, until they are used by the insurance agency, at which time they are "expensed" by the FSLIC and the institution. Further, as the FSLIC uses the funds, additonal deposits may be requested, so long as the total amount deposited does not exceed the 1% limit. Interest is to be paid on funds deposited at a rate equal to the rate of return on FSLIC investments in Government securities.

The bill provides that deposits are to be returned to an institution if FSLIC insurance is terminated or dropped, but not if the institution is liquidated.

Comment The FHLBB proposal accomplishes two goals. First, it clears up any questions which may exist as to the purpose for which the deposited funds may be used. Second, it provides that the deposits are to be considered part of the reserve of the FSLIC and an asset of the insured institution, until used.

Section 201 - Short Title: "Insurance Premiums Authorization Act of 1985"

Section 202 - Under current law, the FSLIC may assess additional premiums against insured institutions. However, these premiums cannot exceed 1/8th of 1% of the total amount of accounts at these institutions.

This section retains current law, but also gives the FSLIC the authority to assess additional premiums without limit, if the institution is engaging in activities which are not permitted (or in levels not permitted) for federally chartered savings institutions. In assessing these premiums, the FSLIC is to take into consideration the institution's net worth.

Comment This section authorizes risk related premiums based on the activities of the insured institution. Institutions engaging solely in activities permissible for a federal association are not subject to the additional risk premium. Institutions which go beyond these activities may be assessed a risk premium, without any statutory limit. However, the FSLIC must take the institution's net worth into account. Presumably, premiums for certain activities may be set so high as to make it economically impossible to engage in those activities. Finally, it should be noted that the range of activities which may be engaged in without a risk premium is set at the activities permissible for a federally chartered thrift, and not at those permissible for a multiple s&l holding company.

Section 301 - Short Title: "Federal Home Loan Bank Board Enforcement Powers Expansion Act of 1985"

Section 302 - Current law authorizes the FHLBB and the FSLIC to issue cease and desist orders. Such orders may include requirements for affirmative action, but it is not clear how far these affirmative action orders may go. For example, in *Otero Savings and Loan v. FHLBB*, 665 F.2d 279 (1981), the court held that the Board could not remedy past violations of NOW account laws by affirmatively ordering an association *not* to engage in NOW account transactions which became legal prior to the issuance of the order. And in *Citizens State Bank v. FDIC*, 751 F.2d 209 (1984) the court held that a similar statute did not permit the FDIC to order that an insured bank pay restitution to depositors who were harmed by the bank's actions, distinguishing situations in which restitution to a bank by officers and employees was permitted.

This section provides that affirmative actions may include restitution, rescission, the disposal of loans or assets, guarantees against loss, and such other actions as the FSLIC or the FHLBB deem appropriate.

Section 303 - The enforcement provisions apply to an insured institution, a savings and loan holding company, subsidiaries of a savings and loan holding company, and to "any affiliate service corporation." The term "affiliate" is not defined for enforcement purposes. (Under the Savings and Loan Holding Company Act, "affiliate" is defined to mean any person which controls, is controlled by, or is under common control with an insured institution. The term "control" is defined to mean controlling 25% of the voting shares of a company or controlling the election of a majority of the board of directors).

This section deletes the term "affiliate service corporation" and substitutes the phrase "any service corporation or any subsidiary of a service corporation, whether wholly or partly owned."

Sec. 304(1) - Current law permits the FSLIC and the FHLBB to obtain a temporary cease and desist order pending the resolution of a final order. Under the statute such a temporary order must be based on a finding that the practice in question is likely to cause the failure of the institution, or a "substantial" dissipation of assets, or that it will "seriously" weaken the institution. Thus a high standard is required to obtain a temporary order.

This section deletes the words "substantial" and "serious" thereby lowering the threshold for the issuance of a temporary order.

Sec.304(2) - Many of the enforcement powers granted the FSLIC or FHLBB are premised upon a finding that the safety or soundness of the institution is jeopordized. This finding may be difficult to make if the institution's books and records are in disarray. This section provides that the FSLIC and FHLBB may issue a temporary cease and desist order if the institution's books are so incomplete or inaccurate that the agency cannot determine its financial condition.

Section 305 - Current law authorizes civil money penalties for violations of removal or suspension orders issued by the FSLIC of FHLBB. It also provides that persons convicted of certain crimes may not serve as an officer or director of an insured institution.

This section authorizes the FHLBB or FSLIC to issue civil money penalties for violations of suspension or removal orders issued by any bank regulatory agency. Removal or suspension orders may preclude participation in any manner in the conduct of the affairs of an insured institution. Likewise, individuals convicted of certain crimes may also be precluded from the affairs of an institution.

Sectin 306 - Presently, the term "unsafe or unsound practice" is not defined in statute. One court has ruled that determining interest on the basis of a 360-day year was not an "unsafe or unsound practice" since it did not threaten the institution's financial safety. Gulf Federal S&L v. FHLBB, 651 F.2d 249 (1981). On the other hand, cases in the banking area have held that the term permits the progessive definition and eradication of inappropriate practices. Groos National Bank v. Comptroller, 573 F.2d 889 (1978). In other words, a loose definition permits the agency to deal with problems as they arise.

This section of the bill would define the term "unsafe or unsound practice" to include any action or omission which is, in the opinion of the FSLIC or FHLBB, contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, may be abnormal risk or loss or damage to the institution or the FSLIC.

The bill goes on to make clear that the authority of the agencies extends to officers and employees who resign or leave the institution before an administrative order is final.

Comment Setting out the definition (albeit an open ended definition which provides that an unsafe or unsound practice includes the factors set out), may work to hamstring the agencies in the future. For example, an enforcement order may be challenged on the ground that the practice did not violate "generally accepted standards of prudent operations" in a geographic area, such as Southern California, bringing in testimony from other thrift operators testifying that it is an acceptable practice.

Section 401 - Short Title: FSLIC Protection Act

Section 402 - When a state chartered institution fails, creditor priorities are set by state law. When a federally chartered institution fails, the FSLIC defers to state law in this area. Typically state law provides that all depositors and general creditors are treated alike. Thus, the FSLIC, which is subrogated to the claims of insured depositors, is given no preference.

The bill provides that the FSLIC shall determine by regulation or order the liquidation and distribution of property of failed institutions where the FSLIC has an interest. In setting priorities, the FSLIC must provide that claims for accounts insured by the FSLIC or held by the FSLIC shall be superior to, and paid before other depositors and general creditors.

Comment This section may raise several potential problems. The Constitution states that Congress shall establish "uniform laws on the subject of Bankruptcies throughout the United States." Art. I, Sec. 8. Arguably, if the FSLIC can establish priorities by order for each failed thrift, this uniformity requirement will be violated. Second, since creditors have a property interest in the estate of a failed institution, disruption of that interest may implicate due process considerations. Third, this provision appears to be a very broad delegation of authority, which may raise delegation issues. However, whether or not any of these constitutional questions is sufficient to make this provision unconstitutional is debatable, but these issues could certainly lead to litigation. Perhaps it is better to spell out in the bill the order of priority, or simply to place the FSLIC first and leave the remainder to state law.

Section 501 - Extends the emergency provisions of Garn-St Germain for 3 years, i.e. until October 15, 1988.

99TH CONGRESS
1ST SESSION

H. R. 2444

To protect the Federal Savings and Loan Insurance Corporation.

IN THE HOUSE OF REPRESENTATIVES

MAY 8, 1985

Mr. ST GERMAIN (for himself and Mr. WYLIE) (by request) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

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A BILL

To protect the Federal Savings and Loan Insurance Corporation.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. This Act may be cited as the "Federal Savings and Loan Insurance Corporation Protection Act".

SEC. 2. Section 403(c) of the National Housing Act (12 U.S.C. 1726(c)) is amended—

(1) by amending the first sentence thereof to read as follows:

"(c) The Corporation shall reject the application of any applicant if it finds that the capital of the applicant is impaired, or that its financial policies or management are unsafe, or that there is no necessity for such applicant institution in the community to be served; and the Corporation may reject the application of an applicant if it finds that the character of the management of the applicant or its home financing policy is inconsistent with economical home financing or with the purposes of this subchapter."; and

(2) by adding at the end thereof the following new sentence: "If the Corporation determines, after consultation with State regulatory authorities where appropriate, that an applicant for insurance of accounts would unduly burden the examination and supervision capability of the Board or of a State examining authority, the Corporation may reject the application or defer action until such time as the Corporation, after consultation with State regulatory authorities where appropriate, determines that there will be adequate staff to examine and supervise the de novo institution at both the State and Federal levels.".

SEC. 3. Section 406 of the National Housing Act (12 U.S.C. 1729) is amended by adding at the end thereof the following new subsections:

"(g) Notwithstanding any other provision of law, State or Federal, or the constitution of any State, in connection with the liquidation of insured institutions in default, the Corporation as receiver shall make provision for payment of unsecured claims against the estate of the institution in default proved to the satisfaction of the receiver or the Board in the following order:

"(1) Administrative expenses of the receiver, including the costs, expenses, and debts of the receiver;

"(2) administrative expenses of the insured institution: *Provided,* That such expenses were incurred within thirty days prior to the receiver's taking possession, and that such expenses shall be limited to reasonable expenses incurred for services actually provided by accountants, attorneys' appraisers, or examiners that, in the opinion of the receiver, are of benefit to the receivership estate, and shall not include wages or salaries of employees of the Association;

"(3) claims for wages and salaries, including vacation, sick leave pay, and contributions to employee benefit plans earned by an employee of the insured institution within thirty days prior to the appointment of the receiver up to a maximum of $2,000 per person;

"(4) claims of governmental units for unpaid taxes; but no other claim of a governmental unit shall have a priority higher than that of the fifth category below;

"(5) claims for withdrawable accounts to the extent that they are insured by the Corporation or held by the Corporation as subrogee or transferee;

"(6) other claims for withdrawable accounts and all other claims, whether liquidated or unliquidated, which have accrued and become unconditionally fixed on or before the date of default, except as provided below in the succeeding paragraphs of this subsection;

"(7) claims other than those that have accrued and become unconditionally fixed on or before the date of default, including claims for interest after the date of default on claims of the fifth and sixth categories; and any claim based on an agreement for accelerated, stipulated, or liquidated damages, which claim did not accrue prior to the date of the default, shall be considered as not having accrued and become unconditionally fixed on or before the date of default;

"(8) claims that have been subordinated in whole or in part to general creditor claims, which shall be given the priority specified in the written instruments that evidence such claims; and

"(9) claims by holders of nonwithdrawable accounts, including stock, which shall have priority within this ninth category in accordance with the terms of the written instruments that evidence such claims.

"(h) Interest after the date of default on claims of the fifth and sixth categories of subsection (g) shall be at a rate or rates adjusted monthly to reflect the average rate for United States Treasury bills with maturities of not more than ninety-one days during the preceding three months.

"(i) All unsecured claims of any category of priority described in (g)(1) through (g)(9) above shall be paid in full, or provision made for such payment, before any claims of lesser priority are paid; if there are insufficient funds to pay any class of claims of one priority in full, distribution to claimants in such class shall be made pro rata; and notwithstanding anything to the contrary herein, the receiver may at any time, and from time to time, prior to the payment in full of all claims of a class having higher priority, make such ratable distributions to claimants in priority classes (l) (1), (2), (3), (4), (5), and (6) as the receiver believes are reasonably necessary to conduct the receivership: *Provided,* That the receiver determines that adequate funds exist or will be recovered during the receivership to pay in full all claims of any higher priority.".

SEC. 4. Section 408(m) of the National Housing Act (12 U.S.C. 1730a) is amended to read as follows:

"(m)(1) Notwithstanding any provision of the laws or constitution of any State or any provision of Federal law, except as provided in paragraph (2) of subsection (e) of this section; subsection (l) of this section; or paragraph (3) of this subsection, the Corporation may authorize in its discretion—

"(A) the merger, consolidation, or transfer of assets or liabilities, in whole or in part, of an insured institution that is eligible for assistance pursuant to section 406(f) of this Act (target) with or to another insured institution or institutions or an insured bank or banks, as defined in section 3(h) of the Federal Deposit Insurance Act;

"(B) an insured institution, insured bank, or any company to acquire or acquire control of a target; or

"(C) any company to acquire assets or assume liabilities of a target, in whole or part: *Provided*, That the Corporation determines that severe financial conditions exist that threaten the stability of a significant number of insured institutions or of insured institutions possessing significant financial resources and that such authorization would lessen the risk of the Corporation.

"(2) Mergers, consolidations, transfers, and acquisitions under this subsection shall be on such terms as the Corporation shall provide.

"(3) If otherwise required by law, a transaction authorized under this subsection shall also be approved by the primary Federal supervisor of a party thereto that is not an insured institution.

"(4) The Corporation shall inform the State official having jurisdiction of a State chartered target ('State supervisor') prior to the effective date of a transaction authorized under paragraph (1) of this subsection; and the State supervisor shall be given a reasonable opportunity, not less than forty-eight hours, to object to the transaction. If the State supervisor objects during such period, the Corporation may effect such transaction only by unanimous vote of the Federal Home Loan Bank Board. The Federal Home Loan Bank Board shall provide to the State Supervisor, as soon as practicable, a written certification of its determination.

"(5) In considering authorizations under this subsection, the Corporation may solicit such proposals as it deems practicable from prospective acquirers, purchasers, or merger partners that the Corporation determines, in its sole discretion, are both qualified and capable of acquiring the assets and liabilities of the target.

"(6) In determining its costs or risks under section 406(f) of this Act or this subsection, the Corporation's calculations and estimations shall be determinative. The Corporation may set reasonable time limits for offers or proposals.

"(7)(A) If a bank or bank holding company acquires a target or its liabilities, any existing office, branch, or other existing facility of the target may be retained and operated by the institution acquiring such office, branch, or facility, but such institution shall otherwise be subject in this respect within any State to the conditions upon which a national bank may establish and operate branches in such State in which such retained office, branch, or facility of the target may be located. No such retained office, branch, or facility of a target may be relocated if a national bank located in the same State would be prohibited from such relocation, except for a relocation within the same market or service area of such retained office, branch, or facility.

"(B) Notwithstanding the provisions of subparagraph (7)(A) of this subsection, if the home office of an institution retaining an office, branch, or facility of a target is not located in the State in which the home office of the acquiring bank or of the principal banking subsidiary of the acquiring bank holding company is located, and if such retaining institution does not qualify as a domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954, or does not meet the asset composition test imposed by subparagraph (C) of that section on institutions seeking so to qualify, such institution shall be subject to the conditions upon which a national bank may retain, operate, or establish branches in the State in which the home office of such institution is located.

"(C) The Corporation, for good cause shown, may allow an insured institution not more than two years to comply with the requirements of subparagraph (7)(B) of this subsection.

"(8) For the purpose of this subsection, 'State' shall include any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, and any territory of the United States.

"(9) Notwithstanding other provisions of law, this subsection shall be repealed, effective upon the expiration of six years after the date of enactment of section 123 of the Garn-St Germain Depository Institutions Act of 1982.".

SEC. 5. The National Housing Act, as amended herein, is further amended by adding, after section 408 (12 U.S.C. 1730a) a new section 408a to read as follows:

"SEC. 408a. No insured institution shall, directly or indirectly or through a subsidiary, commence or continue for more than three years after enactment of this amendment, any business activity other than—

"(1) loans, investments, and activities to the same extent authorized to be made or engaged in by Federal savings and loan associations, by legislation or regulation;

"(2) business activities which multiple savings and loan holding companies and their subsidiaries are authorized to engage in pursuant to section 408(c)(2) of this Act (12 U.S.C. 1730a(c)(2)) and regulations of the Corporation thereunder; and

"(3) furnishing or performing such other services as the Corporation may approve or may prescribe by regulation as being a proper incident to the operations of insured institutions and not detrimental to the interests of savings account holders therein.

The Corporation may, upon a showing of good cause, extend such time from year to year, for an additional period not exceeding three years, if the Corporation finds such extension would not be detrimental to the public interest.".

Section-by-Section

Section 1. This section states the title of the Act as the "Federal Savings and Loan Insurance Corporation Protection Act".

Section 2. This section requires the FSLIC to reject an application for insurance if there is no necessity for the applicant institution in the community to be served. This section also confirms the Corporation's authority to defer action on applications until it is satisfied that there is adequate supervisory capability at both the state and federal levels. Finally, it permits the Corporation to deny applications on the grounds of inadequate regulatory supervision.

Section 3. This section clarifies the Corporation's rights, as receiver, to assume the position of a lien creditor, bona fide purchaser or equity receiver against transferees of property of an institution in default and specifies, as a matter of pre-emptive federal law, priorities of unsecured loans against the receivership estate. It places insured deposits ahead of uninsured deposits and general creditors in the priorities of distribution in FSLIC receiverships.

Section 4. This section amends section 408(m) of the National Housing Act (as added by section 123 of the Garn-St Germain Depository Institutions Act of 1982) to remove the bidding and priority provisions of the present statute and to clarify its other terms.

Section 5. This amendment prohibits state-chartered, FSLIC-insured institutions from engaging in activities not of the type or in excess of the level permitted for federally-chartered thrifts, for multiple savings and loan holding companies, or by the Corporation, by regulation.

Chairman **St Germain**. Mr. Wylie.

Mr. **Wylie**. Thank you very much, Mr. Chairman.

I would like to take this opportunity to welcome our distinguished witness to the subcommittee this morning. He is here to discuss what I, too, believe is the bedrock of our entire financial system, not loopholes and additional powers but safety and soundness.

This subcommittee began its study of the issue about a month ago when we commenced hearings on the financial condition of depository institutions and their insuring agencies and as you mentioned, we next turned to academia for their views on the various proposals to reform our system of deposit insurance.

We then had a panel before us of industry leaders where we learned of their perspective on the issues. Finally, today we are receiving the advice and counsel of the Federal regulator who supervises our Nation's thrift institutions.

Chairman Gray is directly on the firing line to ensure the safety and soundness that I speak of. His legislative proposals which Chairman St Germain and I introduced at his request proved to be an important beginning and provided for much discussion with our previous witnesses.

While Chairman Gray's bill differs in detail with the FDIC proposal, they both have the same goal, that of protecting the deposit insurance funds and to handle problem and failed institutions more effectively. I understand, Mr. Chairman, that Chairman Isaac, who was scheduled to be here today, will not be with us as the Senate confirmed his successor, Mr. William Seidman, last night and even though Bill Isaac did not join us today, I would like to take this opportunity to express my thoughts with respect to his tenure at the FDIC.

I have seen him struggle through times of great change in the industry and economy, inflation, high interest rates, and deregulation of the liability side of the balance sheet in insurance institutions. In addition, there were struggles he encountered as a witness before this subcommittee—Penn Square and Continental Illinois certainly come to mind. In his dedication to the FDIC, he often spoke his mind on these issues, not always saying what people wanted to hear, but instead, telling us what we needed to hear.

It is an honor for the State of Ohio to have a native and fellow Buckeye serve our country in this way. On behalf of the Republican members of this committee, I would like to sincerely thank him for his admirable public service and wish him well in the future.

Mr. Chairman, I ask unanimous consent to insert Chairman Isaac's statement in the record.

Chairman **St Germain**. Without objection, so ordered.

[The statement referred to follows:]

Statement on
Deposit Insurance Reform

presented to the

Subcommittee on Financial Institutions Supervision, Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

by

William M. Isaac, Chairman
Federal Deposit Insurance Corporation

Room 2128, Rayburn House Office Building
October 17, 1985
10:00 a.m.

Mr. Chairman, members of the Subcommittee, it is a privilege for me to present the views of the FDIC on deposit insurance reform and related supervisory issues.

It is not hyperbole to characterize the changes now taking place in the financial system as revolutionary. A structure put into place a half century ago, at the nadir of the Great Depression, is crumbling. In part this is occurring by design, but in larger part it is caused by the forces of economics and technology. The central question facing government today is not whether change will or should continue but, rather, how to insure that the financial structure that eventually results will best serve the public interest.

Deposit insurance has been an integral part of the financial system for over a half century, responsible in considerable part for the depository institution structure that has evolved and the nature of supervision and regulation of depository institutions. It is, therefore, impossible to consider any government action to fundamentally alter the financial structure without addressing the role of the insuring agencies.

Mr. Chairman, you have assembled many distinguished witnesses to testify at these hearings. They have offered a variety of opinions on how best to reform the system. At one end of the spectrum, some people advocate that we dismantle much of the governmental infrastructure and place virtually total reliance on market forces. At the other end, some espouse a greatly expanded role for the government, particularly at the federal level.

We believe that each of these represents an extreme point of view. Proponents of the first approach would turn the clock back to 1925 and pretend the financial collapse of 1929 did not occur. Proponents of the second approach would turn the clock back to the 1960s and pretend the past quarter of a century did not occur.

We must endeavor to strike a balance. The collapse of 1929 did occur, and it taught us a lesson we must never forget: the government has a vital role to play in maintaining financial stability. At the same time, we must also recognize that in many respects we overreacted to the trauma of the Great Depression. We were not sure exactly what to fix so we fixed everything in sight, including some things that did not need fixing. We were far too zealous in our efforts to stifle competition and innovation.

Surely, if we have learned nothing else during the past couple of decades, we have learned that the marketplace will not indefinitely tolerate unnecessary and inefficient restraints. Either the restraints themselves or the businesses subject to them will be eliminated.

Deposit interest rate controls are one example. The marketplace forced their elimination. If we had taken much longer to receive and act on the market's message, the damage to our nation's banks and thrifts would have been beyond repair.

There are other artificial barriers to competition that should be reduced substantially or abolished. They are weakening the regulated firms and denying the public the fruits of a fully competitive and responsive financial system. Specifically, I have in mind the restraints on interstate banking, the Glass-Steagall Act and the Bank Holding Company Act.

Since this hearing is not directed primarily at those issues, I will not dwell on them except to state that there are far better and less invidious ways to control potential abuses and concentration of economic resources. I am convinced that each of these three barriers to competition will eventually meet with the same fate as interest rate controls.

The FDIC remains totally committed to deregulation of financial services. It is good for banking, it is good for consumers and it is good for the nation.

But it is essential to recognize that deregulation -- i.e., the dismantling of artificial restraints on competition -- necessarily requires that we strengthen our supervision of banks and that we reform our system of deposit insurance. To fail to do either is a prescription for disaster.

A deregulated environment is more complex, faster paced. It requires more skilled, better trained examiners and analysts. It requires more reliable and sophisticated offsite monitoring systems to enable us to spot potential problems more quickly and better target our scarce personnel resources. Once abuses or unsound practices are uncovered, enforcement actions must be swift and strong.

The FDIC is moving aggressively in each of these areas. We are increasing staff (earlier this year, we implemented a program to increase our examiner workforce by 40 percent over a one-year period), spending nearly $10 million per year to train our personnel, and we are deploying them where they are most needed. Major efforts are under way to improve our offsite monitoring and analysis systems. Our enforcement activities have increased more than fivefold in the past four years and the actions, including fines and removal of officers and directors, are considerably stronger. When banks fail, we are relentless in our pursuit of civil and criminal sanctions against the perpetrators.

While these efforts are critically important, we cannot and should not place total reliance on them. Promulgating countless new regulations to govern every aspect of bank behavior, and hiring thousands of additional examiners to enforce them, would be prohibitively expensive, would undercut the benefits sought through deregulation, would favor the unregulated at the expense of the regulated and would ultimately fail.

We must seek new ways, in the absence of rigid government controls on competition, to limit excessive risk-taking and abusive practices. We must enlist the support of the marketplace to instill a greater degree of discipline in the system. To accomplish this, we must reform the deposit insurance system.

The collapse of the banking system in the 1930s provided the impetus for the FDIC, even though the measure was opposed by President Roosevelt and the American Bankers Association. They believed the system would be too costly and would subsidize marginal, high-risk institutions at the expense of the well-managed firms. A compromise was agreed upon to provide modest coverage of $2,500 per depositor. Larger, more sophisticated depositors remained at risk and were expected to supply the necessary discipline.

Most of the early bank failures were handled by the FDIC as payoffs of insured depositors only. Depositors over the insurance limit were exposed to loss.

Eventually, the FDIC developed and employed more frequently the purchase and assumption transaction, whereby a failed bank was merged into another bank with FDIC financial assistance. The procedure offered some advantages. It was less disruptive because it automatically continued banking services for the failed bank's customers, and it tended to be less expensive to the FDIC because it preserved some of the franchise value of the failed bank.

An unfortunate side effect was that all depositors and other general creditors were made whole, thereby undermining discipline, but this flaw was of little concern in those relatively tranquil days. Only a handful of very small banks failed each year. Interest rate controls prevented banks from bidding for funds, so customers continued to have the incentive to do business with the banks that could offer the best and most convenient services.

The deposit insurance system was largely transformed, through the purchase and assumption technique, into a system of de facto 100 percent coverage. The perception of 100 percent coverage became particularly pronounced with respect to larger banks when the FDIC infused capital into Bank of the Commonwealth in 1972; arranged mergers for United States National Bank in San Diego, Franklin National Bank and a few other sizeable banks during the mid-to-late 1970s; and infused capital into First Pennsylvania in 1980 and Continental Illinois in 1984.

While *de facto* 100 percent coverage, or the perception of it, might not have been cause for much concern in the 1960s, it is enormously troubling in the decontrolled rate environment of the 1980s. How, in a deregulated environment where most depositors do not believe they are at risk, do we insure that funds flow to the vast majority of banks that are prudently operated instead of to the high flyers that pay the highest rates? The answer is clear: we need to restore an element of discipline in the system.

So one major objective of deposit insurance reform in a deregulated environment should be to achieve greater market discipline. This can be accomplished in any one or more of three ways: pull back from *de facto* 100 percent depositor coverage, find new ways to impose discipline through the capital accounts and implement risk-related premiums. These policy options are discussed in more depth in the appendix to our statement.

A second major objective of deposit insurance reform should be to achieve greater fairness in the system. The fairness issue takes two forms. First, there is the question of how bank failures can be handled so as not to discriminate or give the appearance of discriminating against smaller banks. Second, there is the question of how to allocate the cost of the deposit insurance system in an equitable fashion. For example, is it fair that the best bank in the country pays the same price for deposit insurance as the worst bank? Is it fair to exempt from assessments nearly two-thirds of the deposits of Citibank, while exempting only one-third of the deposits of the Bank of America and none of the deposits of the vast majority of the banks? Is it fair to require well-run banks to pay for the extra cost of supervising problem banks? These issues and a number of others, together with our recommendations for dealing with them, are also discussed in the appendix.

Next, there is the question of disclosure. If we place people -- whether depositors, suppliers of capital or both -- at risk in banks, they are entitled to full disclosure regarding the financial condition and practices of the banks. It is as simple as that. There are only two kinds of information about a bank that we believe should not be disclosed. We believe in strict confidentiality of customer information. We would also protect from public disclosure the ratings by bank regulatory agencies. The ratings represent our opinion, not fact. They are sometimes wrong, on either the low or high side, yet they would be accorded overwhelming weight by the public.

Whatever policies are adopted for banks in terms of capital, disclosure and depositor discipline, the rules must be applied equally to savings and loan associations. Partly for this reason, but mostly because of the need to strengthen the federal insurance system, we favor a merger of the FDIC and FSLIC. Our views on this are spelled out in more detail in the appendix.

Mr. Chairman, members of the Subcommittee, I thank you for this opportunity to testify on these matters of vital importance to our nation. We at the FDIC have long felt that the issues of deregulation, improved supervision and deposit insurance reform are inextricably intertwined. We cannot deal with one without addressing the others. This hearing represents an important step toward pulling them together.

If you are successful in this effort -- if you are able to enact a balanced, comprehensive measure that proceeds with deregulation, strengthens the supervisory process and reforms the deposit insurance system -- there is no question in my mind that the financial system will be made infinitely stronger. It will be a more stable and equitable system in which well-run institutions of all sizes will prosper and be fully responsive to the needs of the American public.

I and the FDIC will be more than pleased to assist you in this effort in any way possible.

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APPENDIX

The Subcommittee has requested the FDIC's views on a number of specific issues:

Discipline

There are two principal ways to achieve greater discipline in the banking system: through depositors and/or through the suppliers of capital. A third, complementary approach would be to implement risk-based deposit insurance premiums.

Depositors

Some suggest that the FDIC revert to the insured deposit payoff method for handling all bank failures in order to instill greater discipline. The idea of greater depositor discipline has considerable appeal, but there are some major drawbacks. For one thing, most banks under $100 million (there are about 12,000 of them) would be virtually unaffected because 95 percent of their deposits are fully insured or secured. Their depositors would not impose discipline. That is the way it should be, because efforts to increase depositor discipline should be focused on the "sophisticated" investor. But that brings up another problem. With the help of money brokers, sophisticated depositors, such as financial institutions and institutional investors, will look for ways to get under the insurance umbrella. As it now stands, they will probably be successful.

Another major obstacle blocking the way for depositor discipline is that deposit payoffs simply cannot be used in large banks. Take Continental Illinois for example. At the time of its near collapse, it had only $3 billion or so in insured deposits. With over $16 billion in its insurance fund at that time, the FDIC could have paid those depositors their money. But other creditors holding nearly $37 billion in claims, including some 2,300 small banks with $6 billion in claims, would have had their funds tied up for years in a bankruptcy proceeding. With nearly a million deposit accounts to process, even insured customers would have had to wait a month or two before receiving their funds.

Because of these types of problems, last year the FDIC developed and tested the modified-payoff technique. It retains many of the advantages of a merger of a failed bank, while imposing a degree of discipline on large depositors. Insured accounts are sold through a competitive bid process to another bank, preserving some franchise value and minimizing the disruption to smaller depositors. Instead of forcing uninsured depositors to await the liquidation of assets before receiving any funds, the FDIC conservatively estimates the present value of the receivership's ultimate collections and makes these funds -- up to 60 or 70 cents on the dollar -- available immediately. Additional payments are made if and when collections warrant.

While the modified-payoff technique and similar approaches to depositor discipline have appeal, it is difficult to envision policymakers ever actually using the technique in a very large bank. Market participants will probably never be convinced it will be employed unless and until it actually is.

Before the modified payoff could be used in a big bank, many issues would have to be resolved. The benefits of the exercise would largely be negated unless funds placed by money brokers and other institutional investors were denied insurance coverage. Otherwise, they will simply package and distribute the funds so as to obtain full insurance coverage. The technique would require insuring adequate safeguards to the nation's payment system. The Federal Reserve would have to be willing to provide aggressive liquidity support to viable banks to minimize any ripple effects of a large failure. Even then, completing a modified payoff in a very large bank would entail a number of other problems, ranging from administrative details, such as more extensive recordkeeping requirements for banks to enable the FDIC to promptly identify uninsured funds, to more fundamental issues, such as finding a merger partner and being able to act before uninsured funds are gone. There are other important considerations: what would be the impact on the bank CD market or the financial markets in general, domestic and foreign? Will solvent banks recover from a "run" even with Federal Reserve support? What are the economic implications of such support if extensively applied? Until issues such as these are thoroughly addressed, the FDIC is likely to remain reluctant to adopt an "across-the-board" policy regarding the modified payoff.

On balance, we believe the disadvantages of depositor discipline probably outweigh the advantages. It appears preferable to look to the suppliers of capital as our principal source of market discipline and as a means of handling all failed banks in an even-handed fashion.

Suppliers of Capital

We have informally proposed that the minimum capital requirement for banks be increased from 6 percent to 9 percent over time -- say one-half percent per year for six years. The minimum primary capital requirement would be set at 6 percent with banks being permitted, but not required, to have the additional 3 percent in the form of subordinated debt.

A well-run bank would be able to raise the subordinated debt at little or no net cost -- i.e., the funds would cost the bank about the same as they would yield when invested in loans or other assets. A bank that took greater than normal risks -- whether on or off the balance sheet -- would have to pay a premium for the subordinated debt. A bank that took excessive risks would not be able to obtain the subordinated debt at any price and would thus be precluded from growing. In this fashion, the marketplace would impose a very real discipline on bank behavior. Subordinated creditors, who unlike stockholders do not share in the rewards of successful risk-taking, will be very discerning in providing and pricing capital.

This proposal does not require legislation. It could be accomplished through regulation. But competitive equity would dictate that all three federal banking agencies, plus the Federal Home Loan Bank Board, act in unison. That does not appear likely in the absence of Congressional direction.

If the proposal were implemented, the FDIC could discontinue its efforts to achieve greater depositor discipline. We would recommend leaving the de jure insurance limit at $100,000, but we would in fact provide 100 percent coverage by endeavoring to arrange mergers for failed banks of all sizes.

The 9 percent capital proposal would equalize the treatment of large and small banks and minimize the disruptions from failures, while restoring discipline. The failure rate would almost certainly be reduced significantly, and the FDIC's losses at failed banks would be minimized.

The principal disadvantage of the proposal is that many banks and thrifts would be forced to raise a considerable amount of capital and/or restrict their growth. The burden would fall primarily on thrifts and large banks. A recent FDIC study, using year-end 1984 data, indicates a capital shortfall of $49.1 billion among FDIC-insured institutions, with $5.7 billion of the shortfall in the primary capital component. Banks could meet the higher standards over time by restricting growth, retaining earnings, issuing new capital or a combination of the three.

Some smaller banks have commented that the requirement would be especially onerous for them because, unlike large banks, they do not have ready access to the capital markets. We do not find this argument persuasive. First, as a group the 12,000 banks under $100 million in size currently have average primary capital equal to 9.1 percent. While many are below 9 percent, their deficiency is comparatively modest. Second, to the extent the deficiency cannot be met through retained earnings, controlled growth and the issuance of stock, it can be met through the private placement of subordinated debt with traditional institutional investors such as correspondent banks, insurance companies and pension funds.

While the proposal has drawbacks, particularly for thrifts and larger banks, the FDIC believes that implementation of it is entirely feasible, given a reasonable phase-in period. The advantages appear to outweigh the disadvantages.

Risk-Related Premiums

The FDIC's deposit insurance reform legislation proposes risk-related insurance premiums as a third method for increasing discipline in the system. Today, all banks -- the best and the worst -- pay the same price for deposit insurance. This not only subsidizes excessive risk-taking, it is patently unfair.

We recently published a proposed system for implementing risk-based deposit insurance. We have already received a number of comments from bankers about the system, and they are overwhelmingly supportive.

Currently, banks pay a premium of 1/12 of one percent of domestic deposits for deposit insurance. The FDIC then deducts its losses and operating expenses and rebates 60 percent of the balance to the banks. Except for the past four years, when the FDIC's insurance losses have been extraordinarily high, the net premium after the rebate has averaged about 1/27 of one percent.

The FDIC proposes to divide banks into two risk categories (normal and above normal) utilizing both the examination process and the results of a statistical technique called probit analysis. The probit test would objectively measure key financial ratios relating to factors such as capital, loan performance and earnings. For a bank to be placed in the above normal risk category, it would have to fail the objective probit test and be rated 3, 4 or 5 under the CAMEL rating system, which is derived from on-site examinations.

All banks would continue to pay the same basic charge for insurance (*i.e.*, 1/12 of one percent), but the FDIC would be permitted to vary the rebate between the risk categories of banks. Assuming a resumption of normal rebates, this would mean that a bank in the above normal risk category would pay a net premium of 1/12 of one percent, while a normal risk bank would pay less than 1/27 of one percent (it would receive a *pro rata* share of the rebate forfeited by the above normal risk banks). The FDIC's net income would not be affected.

In addition, the FDIC proposal calls for problem banks to pay the FDIC a charge for the increased cost of supervision they require, not to exceed 1/12 of one percent. Thus, a problem bank's total payments to the FDIC could be 1/6 of one percent, or roughly five times the amount paid by a normal-risk bank.

Unlike some proponents, the FDIC does not view a risk-based premium system to be a panacea -- just a substantial improvement over the *status quo*. It would be less arbitrary and considerably more *fair* than the current system. It would provide a significant, though not overwhelming, financial incentive for banks to avoid excessive risk-taking and to correct their problems promptly. Perhaps as important, it would send a strong signal to a problem bank's management and board of directors.

Some people have criticized the FDIC's proposal because the financial penalty it would impose is perceived to be too modest and because the proposal does not have a sound actuarial basis. The FDIC acknowledges both problems but does not believe they should preclude moving forward. There is no actuarially sound basis for computing deposit insurance premiums at this time, nor will there be in the foreseeable future. We *are* able, today, to allocate the cost of deposit insurance more fairly than is done under the current fixed-rate system. The FDIC feels strongly the time has come to implement a modest proposal along the lines suggested. After a few years' experience, we may well come back to the Congress for authority to undertake a more ambitious program.

Assessment Base

Two major categories of risk exposure for banks -- foreign deposits and off-balance-sheet liabilities -- are not included in the deposit insurance assessment base today, raising questions of fairness and soundness.

Foreign Deposits

When the FDIC was established more than 50 years ago, foreign deposits were comparatively insignificant and were excluded from both insurance coverage and assessments. Two things have changed in the intervening years. First, foreign deposits have grown to nearly 50 percent of total deposits at the top 10 banks. Second, through its actions at Franklin National, First Pennsylvania and Continental Illinois, the FDIC has provided *de facto* 100 percent coverage of foreign deposits. In view of this, is it fair to exempt foreign deposits from the assessment base? For example, Citibank in 1984 paid FDIC assessments of $18.5 million on [illegible] billion of domestic deposits but none on $49 billion in foreign deposits, while Bank of America paid $40 million on domestic deposits of $59 billion and none on foreign deposits of $30 billion. At the same time, thousands of smaller banks throughout the nation paid FDIC assessments on their entire deposit base.

Last year Senator Proxmire introduced a bill to include foreign deposits in the assessment base and lower the basic premium on all deposits from 1/12 of one percent to 1/15 of one percent. The proposal would be revenue neutral to the FDIC but would shift approximately $120 million per year in premiums from smaller to larger banks. The FDIC believes that unless Congress develops an acceptable means for assuring that foreign depositors are not protected when a large bank founders, the bill introduced by Senator Proxmire would represent a significant improvement in the assessment system.

Off-Balance-Sheet Liabilities

Our nation's banks, primarily the large ones, have hundreds of billions of dollars in off-balance-sheet liabilities, which are not subject to FDIC assessments or regulatory capital requirements. Yet if these banks fail, the FDIC will likely be forced to accept the exposure represented by many of these potential or contingent claims. It seems rather obvious this situation is neither fair nor actuarially sound. The question is what to do about it.

One answer is that the regulatory agencies should undertake closer scrutiny of off-balance-sheet risks and factor them into the agencies' capital requirements in some fashion. All three federal banking agencies are working on this project.

But another important step should also be taken. The FDIC's deposit insurance reform bill would establish a uniform set of creditor priorities for all failed FDIC-insured banks, supplanting a hodgepodge of laws throughout the country. An important aspect of this legislation is that it would subordinate off-balance-sheet claims, such as standby letters of credit. This would protect the FDIC against loss and also impose a degree of discipline by encouraging the holders of these claims to be more careful in the selection of their banks. Finally, it would facilitate the handling of failures through mergers by allowing the FDIC to ignore these claims in calculating its "cost test."

If the FDIC's proposal to subordinate off-balance-sheet claims is not enacted, we believe that at least some of these claims, such as standby letters of credit, must be included in the assessment base.

Merger of the FDIC/FSLIC

The FDIC believes that a merger of the FDIC and FSLIC would create a stronger insurance system with greater resources, a larger income stream and a more diversified risk base. It would also facilitate interindustry takeovers of foundering institutions and unify the procedures for handling insurance claims.

The FDIC feels strongly that banks and thrifts should be required to abide by equivalent standards with respect to capital, accounting and disclosure. The FDIC would oppose any legislation to merge the funds which did not include a mandate to phase in common standards in these areas over a period of years.

If the funds were merged, the Federal Home Loan Bank Board would remain the primary supervisor of S&Ls. The FDIC's role would be comparable to the role it plays in national banks -- cooperatively examining larger and troubled institutions and generally helping to provide oversight.

Many bankers are opposed to a merger of the funds because they fear their institutions will be assessed to cover the cost of handling S&L problems. S&L executives have expressed the same concern in the opposite direction. We believe these objections can be overcome by calculating bank and S&L insurance rebates on a separate basis for each industry for a period of years until common standards on capital, disclosure and accounting are fully phased in.

Other Issues

Role of Private Insurance

Even before the recent debacles in Nebraska, Ohio and Maryland, the FDIC was opposed to private or even state-backed deposit insurance plans. The track record for state and private deposit insurance plans in this country, dating back to before the Civil War, is dismal. The plans simply do not have the size, diversity of risk, regulatory authority or the personnel to weather a serious storm.

We believe that any institution which holds itself out to the public as a bank and accepts deposits should be required to obtain FDIC insurance. If a state or private plan wishes to provide secondary coverage above the FDIC insurance limit, we would have no objection, though we believe participation in the secondary plan by individual institutions should be voluntary.

Risk-Based Capital Requirements

Some commenters have suggested that the regulators ought to implement risk-based capital standards to control excessive risk-taking. Depending on what is meant by those who advocate risk-based capital standards, the FDIC is very leery.

It should be recognized that the agencies already employ risk-based capital standards in the sense that poorly performing banks are required to maintain more capital than well-run banks. The federal banking agencies have for the first time in history adopted a uniform minimum capital standard for banks of all sizes. The minimum standard is applicable only to well-run banks. Banks with above-normal loan problems, weak earnings, poor management, excessive interest-rate exposure, a high growth rate or sizeable off-balance-sheet exposure are required to meet a higher capital standard on a case-by-case basis.

What the commenters apparently mean when they refer to a risk-based capital standard is that the agencies should develop an objective formula to substitute for the case-by-case analysis described above. Some have suggested that certain types of activities should be subjected to higher or lower capital requirements based upon the perceived degree of risk inherent in the activity.

This type of system, in our judgment, would be very difficult to implement and has the potential to be highly mischievous. First, there is no objective way to accurately measure levels of risk among different asset categories. Whether a given type of activity is risky (e.g., mortgage lending) is dependent in large part on the quality and experience of the management conducting the activity. Second, perception of risk is of necessity colored by past experience; we unfortunately do not have the ability to see around the next economic corner. Some of the most troubled loans on the books of banks today were perceived by most people to be some of the best loans five or six years ago. Third, we are very concerned that a system of assigning different levels of capital to various types of loans or activities could someday be misused as a device to allocate credit toward or away from certain sectors. Fourth, as contrasted with the 9 percent capital proposal, a risk-based capital system fails to address the central issue of how to handle the failures of large and small banks in an even-handed fashion. Fifth, no formal system of risk-based capital can be designed which will operate as accurately or as fairly as the current informal system under which our examiners use the on-site examination process to evaluate risk levels in banks and make demands for additional capital (above the minimum requirement) on a case-by-case basis. Sixth, we believe that under the 9 percent capital proposal, the suppliers of subordinatd debt will be far more discerning about pricing levels of risk (whether on or off the balance sheet) than any arbitrary formula we could devise. Finally, it will be extremely difficult to obtain interagency agreement on a complicated risk-based capital formula. It has taken the three federal banking agencies nearly fifty years to arrive at a uniform policy on capital, and we would be distressed to see the agreement fall apart within a year of its adoption.

There is one variant of a risk-based capital system that avoids most of the pitfalls mentioned above and, therefore, has considerable appeal. This system, called the "simplified risk asset ratio," would largely exclude U.S. Treasury securities from capital requirements but would include some or all standby letters of credit (in all cases, the current 6 percent minimum requirement would be retained). While this proposal requires some further study, it appears feasible and may represent a significant improvement over the current capital formula. The FDIC is participating in an interagency study of this and other approaches to risk-based capital.

Adequacy of the FDIC Fund

During the FDIC's first 47 years it handled $9 billion worth of failures and suffered insurance losses of $500 million. During the past 4½ years, it has handled over $35 billion in failures, excluding Continental Illinois, and its insurance losses have averaged $1 billion per year. Even while absorbing these record losses, the fund has grown dramatically by over 70 percent from $11 billion at the beginning of 1981 to over $19 billion today. The fund has never been stronger, with an average maturity in its investment portfolio of 2-1/3 years and portfolio market appreciation of $400 million. Gross income from assessments and interest will top $3 billion in 1985 and net positive cash flow is expected to exceed $5 billion.

Some commenters have suggested that the insurance fund be authorized to draw upon general revenues. The FDIC believes this is unnecessary and unwise, and we are adamantly opposed to it. The federal deposit insurance system was designed to be a self-help safety net supported solely by industry assessments. Except for the original seed money, which was repaid with interest before 1950, the system has not utilized a penny of taxpayer funds, and the FDIC is committed to maintaining that tradition.

Enforcement Authority

The FDIC's deposit insurance reform bill would streamline the procedures for instituting enforcement actions against banks and their officers and directors, while maintaining due process safeguards. It would also provide the FDIC the full range of enforcement powers over all insured institutions as unanimously recommended by the Vice President's Task Group on Regulation of Financial Services. We believe these measures are essential and urge their prompt enactment.

FDIC Control Over Activities of State Banks

Suggestions are increasingly being made that because state banks operate with federal deposit insurance, the federal government or the FDIC in particular should be granted the authority to determine the permissible scope of their activities. The FDIC is greatly troubled by this notion.

Our nation has been well served for over a century by the dual or state/federal chartering system. It has been enormously valuable in helping to foster an innovative financial system. The states, for example, invented the checking account, experimented with the NOW account, led the way on various consumer protection measures and are now at the forefront in dismantling geographic restraints and breaking down outmoded, anticompetitive product-line barriers. At other times in our history, particularly in the 1960s, the federal government has led the way.

We believe the federal government must be extremely careful not to undermine the dual chartering system, the validity of which Congress recognized as recently as 1978 when savings banks were given the federal charter option under the Financial Institutions Regulatory Act and again in 1982 when the option was expanded under the Garn-St Germain Act. There have been very few state initiatives about which the FDIC has any concerns. We believe we already have the authority to promulgate appropriate safeguards in the few areas that are of some concern.

Our approach has been to carefully avoid prohibiting any activities but to require that certain of them -- for example, securities underwriting -- be conducted in separately capitalized and funded subsidiaries or affiliates. We are comfortable that these and other safeguards we have developed provide adequate protection for our insurance fund.

If it should ever be determined that we require additional authority to proceed along these lines, we would not hesitate to request legislation. We are fully cognizant of the need to preserve the integrity of our insurance fund and of the unique role it plays in maintaining stability throughout the financial system.

Market Value Accounting

There is substantial logic in favor of using market value accounting. If bank balance sheets appropriately reflected the value of loans and investments and various intangibles, balance sheet net worth would be an accurate reflection of the true worth of an institution. Capital standards could be applied in a more uniform fashion and the marketplace could readily gauge the net worth of an institution. Implementing such a system for 20,000 banks and thrifts, however, would be very difficult. There are many assets on the books of banks and thrifts whose value could (and perhaps should) be adjusted to reflect interest rate changes. These adjustments are simplest for investments and, indeed, most large banks publish information on market value appreciation or depreciation of their investment securities. Market value adjustments for performing, quality fixed-rate loans may not be too difficult, either. However, the degree of difficulty increases immensely when we adjust assets for quality. Generally, there is not much of a market for very risky performing and nonperforming loans, and placing reasonable values on these assets may be impossible.

Also, many bank franchises have considerable nonbalance sheet value because of a strong customer base, comparatively low-cost liabilities, operating efficiencies, location, competitive and other factors. These would be extremely difficult to measure. In principle, one might argue that these intangibles are reflected -- along with asset quality and interest rate-associated depreciation -- in the market value of an institution's stock. However, the market value of the stock of an institution with deposit insurance also reflects some value of that insurance. Thus, stock values are an imperfect gauge. Moreover, the vast majority of bank stock does not actively trade in the market and, in the case of thrifts, many are not stock institutions.

A gradual movement toward market value accounting would probably be in the public interest. However, it must be appreciated that even partial market value accounting adjustments might suggest that a very large percentage of the thrift industry is insolvent.

Examiner Staffing and Compensation

During the past several years, the FDIC's examiner workforce has been somewhat reduced in size due to two factors. First, the agency made a decision to reduce the frequency of its examinations of small, nonproblem banks, relying to a greater degree on state examinations of these institutions. This resulted in some FDIC regions being overstaffed, which was corrected through a hiring freeze. Second, as the number of bank failures increased dramatically in 1982-84, a significant number of FDIC examiners transferred to the Division of Liquidation, which experienced enormous growth.

The FDIC, by design, now focuses the vast majority of its examination resources on larger and troubled banks, irrespective of charter, and only samples non-troubled, smaller banks. Because the number of failed and troubled institutions has grown dramatically over the past three years and shows no signs of easing, there is a need to increase examiner staffing to keep pace with the workload. Earlier this year, the FDIC's Division of Bank Supervision was authorized to increase its examiner workforce by 40% over the next 12 months from about 1,500 to 2,100.

In view of the differences in pay between the public and private sectors, I am amazed by the quality of personnel the FDIC has been able to attract and retain. The pay differentials have been widening, and I believe that effective supervision requires more competitive rates of compensation than presently exist, particularly at the upper levels. The FDIC, as an independent agency, has some flexibility on the salaries and benefits it can give employees, but we feel constrained in deviating too far from general government policies. We would welcome an expression from Congress that we should have more flexibility in setting competitive compensation rates.

The following tables provide the information requested by the Subcommittee on staffing patterns, turnover rates and compensation levels for FDIC examiners:

SELECTED PERSONNEL STATISTICS FOR FDIC FIELD EXAMINERS

Year	Average Number of Field Examiners	Field Examiner Turnover Rate	FDIC-wide Turnover Rate
1975	1,655	8.9%	Not Available
1976	1,756	10.1%	13.3%
1977	1,844	8.2%	11.2%
1978	1,960	9.3%	16.6%
1979	1,929	9.8%	13.4%
1980	1,859	10.1%	13.8%
1981	1,856	8.5%	12.6%
1982	1,773	7.7%	7.8%
1983	1,678	9.7%	7.0%
1984	1,578	13.1%	7.0%

Division of Bank Supervision Field Examiner Salaries: Actual and Adjusted for Changes in the Consumer Price Index

	Actual Salary Levels			Adjusted Salary Levels*		
Year	GG-5	GG-12	GG-14	GG-5	GG-12	GG-14
1975	$10,111	$21,970	$34,916	$10,111	$21,970	$34,916
1976	10,543	23,166	37,343	9,965	21,896	35,296
1977	11,287	24,799	39,975	10,015	22,004	35,470
1978	11,907	26,167	42,171	9,808	21,554	34,737
1979	13,868	27,995	45,126	10,265	20,722	33,402
1980	15,129	30,543	49,229	9,869	19,924	32,113
1981	15,850	32,013	51,596	9,368	18,920	30,494
1982	16,491	33,290	53,661	9,182	18,536	29,878
1983	16,491	33,290	53,661	8,900	17,965	28,959
1984	17,064	34,621	55,807	8,837	17,929	28,901
1985	17,750	35,835	57,759	8,875	17,918	28,880

The GG-5 columns are entry level salaries. GG-12 is the highest grade which the majority of field examiners attain. The GG-14 columns are effectively the maximum salaries available to a limited number of field examiners, typically those having significant management responsibilities. It could take 18 years of successful performance at the GG-14 grade before reaching these levels.

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* Adjusted salary levels show the purchasing power of the salaries stated in 1975 dollars.

Mr. Wylie. To the issue of what the insurance fund means vis-a-vis Gramm-Rudman, Mr. Chairman, may I respectfully suggest that we invite someone from Treasury up to testify before this subcommittee and get their view on that issue.

But moving on, we will focus today's hearings solely on the thrift insuring agency which may be appropriate considering the range of proposals we have heard over the past few weeks to restructure the FSLIC.

Mr. Chairman, I welcome Chairman Gray to this subcommittee this morning.

Thank you very much.

Chairman St Germain. Chairman Gray, you are duly welcomed before the subcommittee this morning. As you can see, you have the entire forum. It should be an interesting morning. Unfortunately, it is probably going to be very interesting.

I wish it could be interesting due to different circumstances. We will put your entire statement in the record, including the appendices. You may proceed.

STATEMENT OF HON. EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. Gray. Thank you very much, Mr. Chairman.

Thank you, Mr. Chairman, and distinguished members of the subcommittee. I very much appreciate the opportunity to appear before you today to discuss a range of issues and concerns regarding the thrift deposit insurance system—the FSLIC.

I have served as Chairman of the Federal Home Loan Bank Board, which is the operating head of the FSLIC, since June 1, 1983. Only a few days before I assumed the Chairmanship, the Bank Board adopted final regulations implementing the full range of authorities provided to federally chartered savings institutions.

In a very real sense, then, I have been the first Bank Board Chairman whose entire tenure has been devoted to oversight of an industry which, again for the first time, was thrust into an entirely new, different and fiercely competitive deregulated operating environment.

The challenges to the industry and to the regulatory and deposit insurance apparatus which governs the activities of the thrift industry have been momentous, indeed, since then.

It needs to be said here that the thrift industry entered this new environment in a terribly weakened condition, having borne the ravages of 1981 and 1982 which left a heavy toll on the business. During those 2 years alone, the number of FSLIC-insured savings institutions dropped by 750 and the industry's net worth was reduced by at least one quarter.

In the new operating environment of 1983, authorities granted by Garn-St Germain were superseded by far more liberal operating authorities which were authorized by some State legislatures for their own State chartered thrift institutions. Whether State or federally chartered, these institutions all were, and are, members of the FSLIC.

This unprecedented and hitherto unknown combination of diverse operating authorities was bound to bring with it new and unprecedented strains on the thrift deposit insurance system, even though the magnitude of pressures on the system could not have been anticipated at that time.

However, early on in my tenure, the Bank Board did recognize danger signals on the horizon. We saw the emergence of asset quality changes in the portfolios of institutions and we joined with the FDIC in seeking to slow the skyrocketing growth of third-party brokered deposits which we believed were fueling excessive growth in loans and investments.

We believed then, and we have been proven correct over and over again, that excessive deposit growth would bring about unnecessarily risky investments and loans which we feared would sacrifice prudent and sound underwriting practices in a frenzied rush for up-front fees.

Deposit rate deregulation was the law of the land and money brokers provided an unlimited storehouse of easily accessible, albeit, high cost, funds.

Unfortunately, in this period there was on the part of too many savings institutions an "anything goes" attitude; a tendency to confuse the purpose Congress had in mind for thrift deregulation with safety and soundness imperatives, both at the level of the institution and also at the FSLIC.

When the Bank Board sought to revise its net worth scheme for thrifts and to address the risks associated with direct equity investments, a firestorm of opposition from many quarters in the industry met these initiatives.

Later in 1984, the Bank Board decided to hunker down and meet this continuing opposition head on. We adopted a regulation early this year which addressed the excessive growth phenomenon by requiring all FSLIC-insured institutions henceforth to earn their growth. This regulation has not only set in motion the modernization of our net-worth scheme, but also has slowed both asset and liability growth at our institutions dramatically.

We also adopted a regulation which established a review threshold for State-chartered thrifts making direct equity investments. In spite of a resolution signed by more than one-half of the Members of the House of Representatives which was intended, I believe, to derail the implementation of the regulation, the Bank Board made good on its commitment to adopt the measure.

Time does not permit a full exploration in this brief statement of the efforts we have made to initiate changes in rules whose purposes have been to protect the reserves of the FSLIC from loss.

Rulemaking has not come easy in this regard by any means. Nor have we completed the process of dealing with excessive risk to the insurance fund, of course. But progress has been made. And more and more, these changes have met with at least grudging acceptance of many in the industry.

In these months of unprecedented changes in the thrift operating environment, we also have sought to modernize the regulatory oversight structure of our supervisory apparatus. In July, after a herculean and, indeed, successful effort, we transferred our field examiners from civil service status to the Federal home loan banks, thus setting in motion a program to double the size of this force in only 1½ years. We have more than doubled the supervisory staffs at the Federal home loan banks in little more than a year.

Far tougher and tighter supervision of FSLIC-insured institutions is the result of these modernization initiatives.

In early 1984, I warned that the thrift deregulation process was on a collision course with the thrift deposit insurance system. I expressed particular concern on many occasions that our ability at the FSLIC to underwrite the risk of loss to the FSLIC from activities permitted by some State legislatures, especially in the Sun Belt, was difficult at best.

As it turns out, our biggest, our most horrendous thrift failures have occurred at such institutions. Common threads are woven through the fabric of such failure: Exceedingly fast growth, very high levels of brokered funds, very poor underwriting of loans and investments, shoddy management systems and practices, atrocious recordkeeping and documentation and questionable, misleading—and sometimes fraudulent—behavior by those vested with a public trust as insured depository institution executives.

The consequence of the experience—wrought more often than not on the thrift deposit insurance system by high flyers and daredevils who have chosen to play fast and loose on the system with a mentality that can best be described as "heads I win tails the FSLIC loses"—is incredible losses strewn with bad assets. As a result, the losses we have sustained and can look forward to at the FSLIC are far more expensive to deal with than the comparatively minor costs associated with the earnings spread problems encountered by institutions in 1981 and 1982.

The thrift deposit insurance system was not fashioned through its premium structure to bear the burden and magnitude of the losses we face today. We are required by law to operate a group insurance plan and that insurance scheme worked pretty well until we entered the new era of thrift deregulation.

Now we are called upon to underwrite the risk of loss and actual losses, of an industry which is characterized by its diversity. Some State-chartered, FSLIC-insured thrifts are permitted to engage in virtually any activity they wish—far beyond the limits set forth in the Garn-St Germain Act.

They operate on the implicit full faith and credit of the United States and it is the Federal Government, not State treasuries, which is called upon to pick up the expensive failures when they occur.

I do not believe the thrift deposit insurance system can endure long unless it is modernized and a way is found to more effectively underwrite the risk of loss. I have discussed in the statement that I have submitted a Bank Board proposal, made over the last 2 years in legislation introduced by request, to require supplementary insurance premiums of those institutions which engage in activities that extend beyond the confines of what the Congress intended for thrift deregulation. Other options are available to the Congress if it so chooses.

I have also discussed ways in which the thrift deposit insurance fund could be recapitalized. The Bank Board has not proposed a specific recapitalization program. Rather, I have outlined a series of alternatives, none of which is free of difficulties by any means.

Nevertheless, if one agrees that recapitalization is necessary, one also must look at every alternative.

Answers cannot, and do not, come easily when very tough choices are circumscribed by stern realities.

As the Chief Executive Officer of a U.S. Government agency, I believe it is my duty and my responsibility to you in the Congress to keep you informed—as I always have—of the evolving nature of our thrift deposit insurance system, and developments of interest in the thrift industry.

It is in this spirit that I have sought to bring the subcommittee up-to-date in the written statement sent to you yesterday.

Finally, let me say that the thrift industry and the separate, distinct and integral regulatory credit and deposit insurance system which supports it—namely, the Federal Home Loan Bank System—have served this Nation very well. This could very well be the most profitable year in the history of the savings institutions business.

We at the Bank Board have worked very hard to deal with the momentous challenges we have faced during this era of unprecedented thrift deregulation. We have sought to make deregulation work, while at the same time striving to protect the thrift deposit insurance fund.

It has been an arduous, and sometimes thankless, task. I want to thank you, Mr. Chairman, and all of you who serve on the subcommittee, for your understanding and your continuing support of our efforts in this endeavor.

I will be pleased to try to answer any questions you and the members may have.

[The prepared statement of Mr. Gray follows:]

STATEMENT OF
EDWIN J. GRAY, CHAIRMAN
FEDERAL HOME LOAN BANK BOARD

Mr. Chairman and distinguished members of the Subcommittee:

I appreciate the opportunity to discuss with you a range of issues and concerns regarding the thrift deposit insurance system -- the FSLIC.

The FSLIC is a key component of the nation's separate, apparatus which is called the Federal Home Loan Bank System. This system has served our country very well for a half century now and I believe it merits the continued, strong support of the Congress of the United States.

However, the three components of this integral system all need adequate strength to carry out their mission and meet their obligations if the apparatus is to serve the American public

The federal credit supply component of this system -- which takes the form of our 12 Federal Home Loan Banks that serve as central banks to member thrift institutions -- is very strong. These 12 central banks have combined assets of some $100 billion and they are capitalized, largely through federal home loan bank stock held by member institutions, at about 9 percent.

Under my Chairmanship, the regulatory function of the integral thrift system has undergone the first significant modernization in 50 years. The Bank Board has very substantially increased its supervision capability during the last year and half. On July 7 of this year, we transferred our field examination staff from civil service to the Federal Home Loan Banks under delegated authority provided by law. By the end of 1984, we will have increased our field examination team by 34 percent. That increase will have occurred in less than six months. Indeed, by the end of 1986 -- that is to say, over an 18 month period -- the Bank Board plans to achieve a 100 percent increase over the level which existed at mid-year this year.

I want to assure you that the effort we undertook to move a field examination force from the ranks of the federal civil service system to the Federal Home Loan Banks, which are not subjected to federal budget and salary setting constraints, was a herculean task and this Bank Board is extremely proud of that accomplishment. Without its execution, there would have been precious little hope of overcoming the inertia of a process which had severely limited our ability to keep up with the demands -- the absolute necessity -- of providing adequate oversight of the activities of insured savings institutions which, today, operate in a vastly different environment than ever before.

The mere notion that we, in our regulatory capacity, could have continued to monitor effectively regulatory compliance by insured institutions within the severe and constraining limits which had previously been imposed on us by the federal budget and salary setting process, is absurd. Imagine having to examine institutions across the nation, whose assets now approximate one trillion dollars, with a 750-person field examination force whose annual salary was $25,000. Indeed, entry level salaries for field examiners were held to some $14,000 by the federal salary setting process. It is no wonder, then, that turnover rates in five of our districts ranged between 23 and 28 percent a year. A survey we took showed that only half of our examiners had been on the job for two years or more. It was simply impossible to attract and retain field examiners under these conditions -- examiners who are called upon to analyze the books and records of FSLIC-insured institutions which today engage in some of the most sophisticated and intricate financial transactions in the history of finance. As our examination resources are now brought up to speed as quickly as possible, we will begin to have the capacity to carry out the regulatory oversight responsibilities necessary to detect and deal with emerging problems at insured institutions earlier on, and much more effectively.

Again, I cannot emphasize enough the importance of the historic transfer from civil service to the Federal Home Loan Banks of our field examination force. For the reasons I have cited, it portends great hope for the future by laying the groundwork for a much improved and far more effective regulatory oversight process.

This is not to say, however, that the needed modernization of our regulatory apparatus is complete, by any means. I believe the Bank Board needs additional statutory authority to deal with problem cases earlier on. Today, we must be prepared to prove in court that there has been a "substantial dissipation of assets" at an institution before we can issue a temporary cease-and-desist order. The irony is that all too often in problem cases the examiner confronts a situation where the books and records of an institution are in such disarray, that it is impossible to determine during the examination the financial condition of such an institution and, therefore, it is simply not possible to be prepared to prove at the time a "substantial dissipation of assets" -- even though there is every reason to believe this is the case. The time-consuming process of getting needed appraisals to be able to prove such "substantial" dissipation works against us while, in the meantime, we are effectively precluded from issuing the temporary cease-and-desist order. We believe that when the books and records of an institution are in disarray, this alone should provide the statutory grounds, for issuing a temporary cease-and-desist order.

Our supervisory staffs have explicit instructions to immediately seek appropriate supervisory agreements with the boards of directors of institutions or regular cease-and-desist actions when they discover material violations of regulations, statutes, and previously undertaken supervisory agreements.

You recognize I am sure, as we do, that a deregulated operating environment does not imply any lessening of the regulatory process which emphasizes strong supervision. Indeed, in my view, the more deregulation there is, the greater necessity there is for strong and effective supervision of insured institutions. And, effective supervision depends, in large part, on effective examination of these institutions. I cannot stress strongly enough that the greater the deregulation of insured depository institutions, the tougher and more extensive must be accompanying supervision of these institutions. So long as the federal government must cover the risk of loss and actual losses of insured institutions, the regulatory process -- which signifies close supervision -- must, of necessity, be strong and controlling.

I say this because the institutions we regulate operate on the implicit full faith and credit of the United States. That is to say, the insured deposits these institutions use to conduct and fund their operations are -- in practical fact -- backed by the full faith and credit of the United States. Insured depository institutions are not and cannot be free market players, like other entrepreneurial enterprises. Insured depository institutions operate on the federal government`s safety net, in every sense.

Let me say here, parenthetically, that airline deregulation did not mean to suggest that sound passenger safety would be deregulated or sacrificed. The FAA is called upon to enforce and maintain sound passenger safety standards.

The deregulation of federally-insured financial institutions ought not suggest to anyone that the federal safety net which protects insured deposits should be weakened or left unprotected in any way, especially when that safety net guarantees trillions of dollars in depositor funds. The Congress should provide those of us who are called upon to protect the safety and soundness of our federal deposit insurance system the resources and authority we need to maintain a strong and effective insured deposits safety net, just as the FAA is called upon to enforce sound passenger safety in the airline industry.

In light of these concerns, it is interesting, and sometimes perplexing to me, that some in the thrift institutions industry continue to evoke, in the most pejorative terms, the term "reregulation," and to substitute that term for what is, in the truest sense, the principle of "safety and soundness" -- both at the insured institution level, and for the thrift deposit insurance structure.

All too often, some who call up the term "reregulation" may be the same folks who insist on engaging in risky ventures -- ventures which increase the risk of damage to, or even the demise of, their own institutions, and which heighten the risk of loss -- and, as it turns out, very heavy losses in too many instances -- which must be borne by the FSLIC.

I believe in a safe and sound financial system of insured depository institutions where depositor's savings are involved and guaranteed by the government, just as I believe there must be a safe and sound airline passenger system.

The term "reregulation" -- in the sense some are using its pejorative connotations today -- has become a strategic code word, a tactical weapon in their arsenal -- to justify excessive risktaking on the thrift deposit insurance safety net which is simply not possibly equipped to bear the risk of loss, and actual losses, such excessive risktaking produces.

One does not hear the term "reregulation" used in connection with airline passenger safety standards, where life and limb are at risk. However, where the safety and soundness of financial institutions and their deposit insurance safety net are involved, some apparently feel perfectly free to resort to such a misleading code word -- irrelevant and deliberately confusing as it is.

Many of you are aware of my repeatedly expressed concerns in Congressional testimony and in public speeches delivered over the past two years now that the resources of the thrift deposit insurance system, as structured, are limited and finite.

They are limited and finite because the only real source of capital available to the fund is the thrift industry itself through insurance premium assessments. When the inflow of capital from these assessments produces less and less over time relative to the magnitude of losses and projected losses the FSLIC must be prepared to deal with, then the usable insurance reserves of the fund come under more and more strain.

Today, the usable -- that is to say, the unobligated -- reserves of the FSLIC are at $3.2 billion. They are at that level for two principal reasons. First, the special premium assessments the Bank Board has collected since they were imposed earlier this year have produced an additional $750 million thus far. Second, given the magnitude of losses and projected losses to the fund we face -- relative to the resources on hand -- we have not been able to deal with costs associated with such failures, large failures, without causing a severe rundown of the fund's available, usable reserves. As I have said so many times, the resources of the thrift deposit insurance fund are indeed limited and finite.

This is why, quite simply, the fund must be recapitalized. The alternative under the circumstances -- that of deferring action on cases now before us and projected to come before us in the future -- can only result in greater costs to the FSLIC down the road.

As I have said before, and I want to stress this again, so far as insured depositors are concerned, there is absolutely no question in my mind, whatsoever, that the full resources of the United States of America stand behind their accounts at FSLIC-insured institutions.

What you in the Congress must deal with -- and I urge you to act expeditiously -- is the issue of how the thrift deposit insurance fund will be recapitalized. Since we at the Bank Board do not print money, there are in my mind only two sources of recapitalization -- the Treasury, or the thrift industry member institutions of the FSLIC. As you know, the industry, itself, has always provided the capital necessary to enable the fund to meet its obligations to insured depositors. I personally strongly favor recapitalization by the industry as I strongly suspect you do also.

The way to accomplish this is through additional authority for the FSLIC to assess special premiums, or authority by which the FSLIC could require a deposit set-aside from member institutions similar to that enacted last year for the credit unions (NCUA). Under that approach, each member institution would set aside one percent of deposits at the FSLIC and they would be accounted for by the institution as an asset until such time as any portion of the deposit set-aside was drawn down. Then, that portion of the set-aside drawn down would be treated as an expense to the institution. I recognize, of course, that neither of these thrift industry recapitalization approaches can meet with popular acclaim by the industry. However, the only two alternatives to thrift industry recapitalization of the fund, as I see them, are a possible merger of the FSLIC with the FDIC -- which I do not favor -- or a taxpayer-financed recapitalization.

Again, the only alternative to recapitalization is a continuing deferral of action by the FSLIC on major problem cases relative to available resources. Such a deferral of action can only cause case resolution costs to increase further over time. Again, the Congress, in my view, simply must deal with this issue expeditiously.

It is an irony, of course, that at a time when the thrift industry as a whole is highly profitable, and in a year in which the industry as a whole may generate all-time record after-tax profits, we at the FSLIC are faced with a record case load of challenges.

The problems we face at the FSLIC have their origins in the excesses of 1983 and 1984 when industry growth was fueled by high cost insured brokered funds and jumbo certificates of deposit. Deposit deregulation -- that is to say the removal of controls on rates of interest which could be paid to depositors -- was, and is, the law of the land. As I warned repeatedly in late 1983 and 1984, the fast asset growth of too many institutions on too little real capital manifested itself in too many poorly underwritten loans and excessively risky investments. Too many of these loans and investments were geared to achieving immediate up-front fees. In all too many cases, sound, prudent underwriting was simply sacrificed in a frenzied rush for these up-front fees.

I must report to you that the lion's share of our major problem cases, which are very expensive bad asset cases -- cases which are on the FSLIC's doorstep or soon will be -- involve state-chartered, FSLIC-insured institutions. Generally speaking, most of these cases are spread across the sunbelt where operating authorities are substantially more liberal on the asset side than those the Congress authorized for federally-chartered savings institutions in the 1982 Garn-St Germain Act.

In those sunbelt states where operating authorities on the asset side go beyond, or well beyond, what the Congress found suitable for federal deposit insurance for federally-chartered thrifts, we have a situation in which states have authorized such powers, but when losses occur it is the federal government who must pick up the pieces. In my own home state of California, for example, any state-chartered thrift may -- by state law -- engage in virtually any activity it chooses and may place all of its assets in service corporations which are then able to make direct equity investments in all manner of endeavors. Under the 1982 Garn-St Germain Act, only three percent of a federally-chartered thrift's assets may be devoted to service corporations and the nature of the direct equity investments such service corporations may make is prescribed.

In the sunbelt region of the country where most of our big losses and failures are occurring and where liberal asset authorities have been granted by state legislatures to their state-chartered thrifts, these same states require that their thrifts be FSLIC-insured. Not a penny of loss is ever borne by the state. Only Uncle Sam is left with losses when they occur.

What we at the FSLIC operate, then, is a group insurance plan which ultimately is backed by federal taxpayers in which the FSLIC is made to bear the risk of loss and actual losses incurred when institutions fail -- both for federally-chartered thrifts which are limited to what Congress found suitable for group insurance premiums, and for state-chartered institutions which are empowered to operate beyond the limits Congress prescribed for federal thrifts.

Any group insurance plan which is called upon to bear the magnitude of risk of loss and actual losses which stem from such diversity of authorities must, it seems to me, have very "deep pockets" of adequate capital to accommodate loss. Obviously, we at the FSLIC are not endowed with such deep pockets.

In my view, given our experience over the last several years, the FSLIC's group insurance coverage should be contracted down to accommodate only those operating authorities granted by the Congress, and found suitable by the Congress for thrifts, in the Garn-St Germain Act.

In my view, any activities which lie beyond what the Congress, itself, found suitable for federal deposit insurance for federally-chartered thrifts, ought to be subjected in the future to a supplementary insurance premium plan where the pricing of supplementary premiums would be geared to the risk of loss to the insurance fund. Such supplementary premiums would take into account the level of real net worth of an institution which chose to participate in the program, and would proportionally reduce the pricing of premiums as the level of net worth increased. Such supplementary premiums would be assessed on institutions only to the extent they chose to engage in activities beyond those authorized by the Congress for federally-chartered thrifts.

I recognize, of course, that not everyone favors this approach.

There are those who insist at all cost that the FSLIC's current group insurance plan must continue to cover the same risk of loss and actual losses -- irrespective of the diversity of operating authorities granted to state- and federally-chartered savings institutions. Perhaps they can offer a way to provide sufficient deep pockets to underwrite all the risk and pay for all the losses the FSLIC sustains.

There are those who say the supplementary premium program we have proposed is too complex and that supplementary premiums would be too difficult to price. We can always find ways to declare victory over complexity and then go home. But, that simply doesn't solve anything. It is, in fact, nothing more than total surrender to perceived complexity; total surrender to the status quo. I'm not suggesting that it would be easy to price supplementary premiums, but few things worth doing are ever easy.

There are those who say anything the FSLIC would do in the pricing of supplementary premiums would be arbitrary. The fact is, however, that the pricing of our present single group insurance premium is completely arbitrary. Every institution now pays exactly the same group insurance premium relative to deposits -- irrespective of net worth and irrespective of the riskiness of the activities an institution chooses to engage in.

The present premium structure is the most arbitrary insurance scheme of all.

The existence of supplementary premiums and the pricing of supplementary premiums commensurate with the risk of loss to the FSLIC would, in fact, be significantly less arbitrary than our current group plan scheme.

There are those who say that such a supplementary premium program would not produce revenues sufficient to solve present problems. No it would not, nor is it intended to do so. The supplementary premium program would only be prospective in nature. However, what the supplementary premium scheme would do is to more fairly allocate the cost of risk among institutions which choose to engage in activities the Congress determined not to authorize for federally-chartered thrifts. Again, the higher the net worth of an institution, the lower the pricing of the supplementary premium. The heavy use of direct equity investments is one of the categories which so differentiates some state-chartered institutions from federally-chartered thrifts. Our evidence indicates very clearly that direct equity investments are, in fact, more risky than debt instruments. Many of our large problem cases reflect the heavy use of direct equity investments, whether or not such equity investments were misclassified as loans.

Some say they would have great concern that "a bunch of government bureaucrats" could price supplementary premiums. In fact, the Bank Board would call together the best private sector insurance underwriter pool of talent available to review relevant data and recommend such premium pricing to the three members of the Bank Board who then would make the final decisions. This is not very different from the way the Bank Board now acts on recommendations from the Office of Finance of the Federal Home Loan Banks, and from the staff of Freddie Mac, to price debt issues. The Board makes the final pricing decisions before such issues go to market.

Finally, some say state-chartered institutions should not be allowed to engage in activities not authorized by the Congress for federally-chartered thrifts. That is always a call the Congress can make if it chooses.

The Bank Board first proposed the supplementary risk premium scheme I have outlined here in the spring of 1984 and it was subsequently introduced along with other Board legislative proposals in both the Senate and the House by request last year. We requested that it be introduced again this year and it was, in both the Senate and in the House.

We have consulted with a major international insurance brokerage and consulting firm, the Frank B. Hall Company of New York, and that firm has found our approach to be workable and feasible. Clearly, at the beginning, as data were compiled to establish experience in the pricing of the risk of loss, we would have to use a surcharge and/or rebate approach to accomplish supplementary premium pricing. It would be necessary to fine tune pricing, especially at the outset.

The prospective supplementary premium scheme we have proposed would produce additional revenues for the FSLIC in the future. Such additionally supplementary premiums would be intended to cover the risk of loss to the FSLIC for activities covered on an ongoing basis. The supplementary premiums would not, of course, cover losses already incurred. The main purpose of the proposal is to more fairly allocate the cost of risk to the FSLIC paid by member institutions. In my opinion, this is an important point to make because FSLIC premium payers have a right to expect a fairer allocation of this cost in the future. Why should the high flyer, the institution which chooses to take greater risks, be able to pay the very same insurance premium relative to deposits as the more conservatively run, more prudently run, more responsibly operated institution? Why should institutions which build up their net worth to solid, strong reserve positions -- and thereby cushion their own losses -- be asked to pay the same premiums relative to deposits as those who do not?

For many years, our thrift deposit insurance system worked remarkably well because the diversity of operating authorities between state-chartered thrifts and federally-chartered thrifts was comparatively minimal compared to the diversity which exists today. Federal and state thrift operating authorities moved back and forth into relative parity through the years. The savings institutions business was highly regulated and was essentially confined to mortgage finance. For years, thrift institutions were subject to specific rate controls on interest they could pay depositors. Institutions worked off a simple spread between the cost of money and long-term, fixed-rate yields on home mortgages. Losses to the FSLIC from thrift failures were relatively infrequent and such losses could be handled quite easily compared to today. In the decade of the seventies, loan underwriting errors generally were accommodated by institutions without extreme danger because real estate inflation covered such errors quite nicely.

Today, all of that has changed. Inflation no longer bails out underwriting mistakes. This is a period of real estate deflation. Rate controls on interest paid for deposits are gone. Underwriting of all types of lending and investment instruments requires a sophistication never before needed by thrifts. Futures, interest rate swaps, adjustable rate mortgages, access to the capital markets for debt, mortgage securities, and a host of other intricate financial complexities are part and parcel of the thrift institutions scene now.

In spite of the changes in our new thrift operating environment -- the most momentous changes in a half century for the industry I regulate -- we still are required to run our thrift deposit insurance system the same way we did in the 1930s and 1940s.

If we do not change the way we underwrite the risk of the loss to the insurance fund, the thrift deposit insurance system will have no future.

In my opinion, a modernization of our financial system requires a similar modernization of our regulatory apparatus, which we are striving to achieve to the extent we can within our present statutory authority, and a modernization of the thrift deposit insurance structure, so we can, indeed, be able to accommodate the risk of loss and actual losses with adequate capital.

I believe we must begin now to achieve the short-term and long-term objectives necessary to accomplish this. We need to recapitalize the FSLIC. We need to put in place a better means to underwrite risk of loss to the fund. We need to make the allocation of the cost of risk in our insurance premium structure much fairer than it is. Irrespective to how this is done, I believe these goals simply must be accomplished. They can only be accomplished by the Congress. And, the time for you to do it is now.

APPENDIX A

1) Modified Payoff

The Subcommittee has requested that the Bank Board comment on the proposal of the FDIC to modify its deposit payoff procedure used in the event of a bank failure and appointment of the FDIC as receiver. This "modified payoff procedure" was published for public comment in the Federal Register on May 6, 1985.[1]

The modified payoff procedure transfers only the insured deposits and certain performing assets of the failed institution (e.g., physical facilities, cash assets, performing consumer loans) to the acquiring institution. The uninsured and unsecured creditors, rather than waiting until the liquidation of the remaining assets has been effected, receive a percentage of the estimated present value of the assets in proportion to their uninsured or general creditor claims. This modifies the result achieved because the uninsured creditors do not receive 100 percent coverage, but rather suffer some loss due to the risktaking and subsequent failure of the bank.

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[1] 50 Fed. Reg. 19088 (May 6, 1985).

However, use of the modified payoff procedure still provides more coverage, at risk to the FDIC, than a straight forward payment of insurance. The modified payoff guarantees general creditors and uninsured creditors a set percentage return on the liquidated assets; however, if the assets return a smaller amount than anticipated, the FDIC has stated that it would not attempt to seek reimbursement of the difference from those general creditors and uninsured depositors. Further, if the liquidated assets return more than estimated, the unanticipated surplus would be distributed to the general creditors and uninsured depositors. This improves market discipline over use of the purchase and assumption method because some loss is experienced by creditors and uninsured depositors. However, a risk of loss greater than that incurred through an insurance payment remains with the FDIC.

The Bank Board, as operating head of the FSLIC, believes that there could be a better method for handling insured institution failures than either the purchase and assumption or modified payoff methods. We support and strongly urge amendment of the FSLIC's authority in liquidation proceedings to allow the Corporation to determine, by regulation, the order of priority for the distribution of property in payment of unsecured claims to provide for the superior and preferred status of insured deposits over the claims of general creditors and uninsured deposits. Such authority would allow the FSLIC to structure solutions to problem institutions that preserve the integrity of the insurance of accounts up to the $100,000 federal deposit insurance limitation, without providing excess coverage of general creditors and uninsured depositors.

The need for a legislative change in the FSLIC's authority is due to the current status of the common law and statutory authority which usually requires general creditors and uninsured depositors to be treated equally with insured depositors -- and the FSLIC as their subrogee -- in any recovery from the assets of the failed institution.

If this system were changed, the FSLIC would be provided with the power to transfer merely the insured accounts to a healthy institution and subject the claims of the general creditors and uninsured depositors to a real risk of loss in the liquidation of the failed institution. This would create a true marketplace incentive to discipline institutions engaged in speculative and risky endeavors.

2) Subordinated Debt Capital

The Bank Board has supported the use of subordinated debt by thrifts so long as such use is within the regulatory framework established by the Board. The Board's main regulatory concern with the use of subordinated debt is to insure that the growth of an insured institution is supported by a real increase in capital and net worth. Subordinated debt has been allowed to be included as a part of regulatory net worth for insured institutions since 1973. Although the Board recognizes that subordinated debt lacks permanence due to the obligation of the institution to repay the debt, use of long- and medium-term subordinated debt affords protection to the FSLIC in the event of insolvency of an insured institution by virtue of its subordination to the other obligations of the institution. Thus, subordinated debt provides a cushion against losses incurred by the FSLIC as a result of the issuing institution's insolvency and transfers a portion of the risk of loss from the FSLIC to the purchaser of the subordinated-debt security.

In April of 1985 the Bank Board amended its subordinated debt requirements to prohibit the sale of such debt securities to other FSLIC insured institutions or their corporate affiliates. This prohibition was deemed necessary to insure that, in the event of the issuing institution's insolvency, the risk of loss was not merely shifted from one insured institution to another, but was truly transferred to an independent non-FSLIC insured entity.

3) Risk-related Deposit Insurance Premiums

In insurance terminology, the FSLIC insurance coverage, as currently structured, creates a hazard in that the insurance protection becomes an external substitute or addition to the equity or risk capital of thrift institutions.

In addition, thrifts chartered by some states have been granted far different investment powers than in other states, and more importantly, than those provided under federal law for federally-chartered savings institutions. This diversity among thrift operating authorities has enables some institutions to engage in improper and/or excessive risk-taking relative to the internal risk capital of the institution. When the financial risk arising from any course of action is shifted in whole or in part to another economic entity such as the FSLIC, the incentives to manage and control the risk are correspondingly reduced giving rise to distortions in the market.

In the spring of 1984, and again this year, the Board proposed to the industry and to the Congress the best and most practical plan we could devise to try to price the risk of loss to the insurance corporation for activities institutions choose to engage in.

We took the position that in the Garn-St Germain Act, Congress determined what activities it felt were suitable for federal deposit insurance for thrifts. Using this rationale, we concluded that those activities which go beyond what Congress found suitable for coverage by our FSLIC group insurance plan ought to be subjected to supplementary premium pricing -- based on the risk of loss from such additional activities to the FSLIC.

Grouping or combining certain activities based on risk of loss, and subjecting such activities to risk premium pricing would necessarily be less arbitrary than the present group plan, because the cost of FSLIC insurance would reflect the risks that institutions determine for themselves to undertake. Institutions would then know in advance what kind of a risk premium they would have to pay -- depending on the extent to which they wished to engage in the activity, and the level of net worth they held.

We have consulted with industry experts regarding implementation of our risk premium concept. And a nationally recognized insurance firm has been retained to perform a comprehensive review of our plan and provide operational recommendations.

Their final report proposes a schedule of supplemental premium charges for investment activities which exceed the limitations established by the Garn-St Germain Act. There would be no change in premiums for activities which fall within the Garn-St Germain parameters. More specifically, supplemental premium charges would be set in advance for each type of asset based activity exceeding federal limitations. This would enable institutions to evaluate the charges before deciding to engage in certain activities. Moreover, the charges would vary depending on the relative riskiness of each activity and with an institution's capacity to assume increased risk as measured by its net worth. Supplemental premiums would be higher for the most risky activities and for those institutions with the lowest net worth. Finally, risk categories would be periodically reviewed based on a revised quarterly reporting system designed to capture data for assets that exceed federal limitations.

4) Risk-related Capital Requirements

We applaud the concept of risk-related capital requirements. In theory, there could produce results similar to those of risk-related premiums in that both should reduce excessive risk-taking. As I will explain below, the Board has already taken one important step in this direction in its net worth regulation, passed last January.

Nevertheless, since the thrift industry is currently under capitalized, proposals to increase capital levels -- regardless of how well intended -- would simply exacerbate that problem. We believe that our risk-based premium approach which is tied to institutions' capital level is a far better solution to improving the net worth levels of FSLIC-insured institutions because it will impose market discipline over time.

As I mentioned earlier, we have proposed that variable insurance premiums shall be set by the FSLIC with regard to an insured institution's level of net worth as compared to its outstanding liabilities. Thus, for two institutions with identical portfolios, an institution with very high real net worth would pay proportionately less in supplementary premiums than the less well-capitalized entity, given the protection that very high net worth affords to cushion the risk of loss to both the institution and the FSLIC.

The Board has also, by regulation, taken steps to strengthen the capitalization of individual insured institutions and the industry as a whole as a means of reducing risk to the FSLIC, thus leaving it less vulnerable to interest rate swings and changes in economic conditions generally.

The final regulation adopted by the Board in January of this year revising net worth requirements for insured institutions addressed the increased riskiness of direct investment, because of its higher risk-return trade-off, by imposing an additional "contingency reserve" amount, to be added to the overall net worth requirement, equaling 10 percent of certain investments. Hopefully, as the capital position of the thrift industry improves, further actions along these lines will become feasible.

5) Insurance Fund Recapitalization

Recapitalization of the FSLIC is the second prong of comprehensive deposit insurance reform. In order to assure that our insurance corporation will always be able to meet its obligations, some form of recapitalization of the fund is imperative. Let me say at the outset that our risk based premium plan must be inextricably linked to any form of recapitalization of the fund. Strongly capitalized FSLIC-insured institutions would surely be penalized by a recapitalization of the fund if institutions that choose to engage in higher risk taking in the future did not have to pay for the right to do so under our risk based premium plan.

The enormous and unique strains on the FSLIC over the last five years of deregulation require a forthright recognition by the thrift industry and by the Congress of the growing need to recapitalize the insurance fund to assure its ability to carry out the vital role of underpinning our Congressionally-created system of support for home finance. This can only be done through a willingness and commitment to strengthen the ability of the FSLIC to meet its own financial obligations.

The model used by the National Credit Union Share Insurance Fund last year is a means by which this could be accomplished. However, without a fairer allocation of the cost of risk assessed through the premium structure on insured institutions, I do not believe it will be possible to gain widespread thrift industry support for such a recapitalization proposal. Strong FSLIC-insured institutions may be willing to accept such a recapitalization of the fund if they can be assured that those institutions who choose to engage in higher risk taking in the future will have to pay for the right to do so, commensurate with the risk of loss to the FSLIC.

The issue simply comes down to how important it is to the industry and to Congress to maintain and preserve the unique, separate and distinct regulatory, deposit insurance and credit provision apparatus that savings institutions have benefitted from so greatly during the past five decades. I believe that recapitalization of the FSLIC insurance fund is at the very heart of this issue, and it simply must dealt with and not left to polemics which produce inadequate answers.

How the fund is recapitalized is clearly a legitimate subject for discussion. Nevertheless, however recapitalization is accomplished, it must be done.

6) 100% Deposit Insurance Coverage.

While the Bank Board is cognizant that the current level of deposits in excess of the $100,000 insurance limitation held by thrifts nationwide is less than 10 percent, the Bank Board opposes 100 percent deposit insurance coverage for a number of reasons. Most notably, the Board believes that the likely result of such an extension would be the elimination of any incentive for depositors to impose discipline on the risktaking activities of insured institutions. Such an extension would necessarily remove any possibility that imprudent management or investment policies would place deposits at risk. As noted in our statement, the current flat rate premium structure already distorts risk enormously by encouraging institutional gambling at the FSLIC's expense. Legislating 100 percent insurance would generate even greater distortions by handing insured institutions a totally blank check drawn on the FSLIC for their use in any endeavor, regardless of the risk or speculative nature of the loan or investment.

Moreover, providing 100 percent insurance would encourage depositors to seek freely the highest rate of return and financially troubled thrifts would be encouraged continually to outbid each other for those funds, necessitating further investment in questionable projects in order to pay higher and higher rates of return. One-hundred-percent deposit insurance coverage would also have the likely effect of encouraging depositors to consolidate accounts held in several institutions into one, resulting in an increased volatility of such accounts and the likelihood of liquidity shortfalls as deposits are withdrawn to seek higher interest rates.

The Bank Board might be able to moderate the likely runaway effects of such a policy through its net-worth and direct-investment regulations, but the damage to the public's stake in maintaining deposits in institutions which responsibly and prudently manage their assets and liabilities and safeguard the monies of depositors would be devastating. The Bank Board cannot support the erosion or elimination of depositor discipline of risk taking institutions at a time when such market discipline is essential for the protection of the FSLIC. For these reasons, the Bank Board supports retaining the current limits on deposit insurance coverage as part of a multifaceted program to protect the FSLIC and strengthen the thrift industry.

7) Reduced Deposit Insurance Coverage.

The Bank Board is satisfied with the current $100,000 level for federal deposit insurance. Maintenance of the present level has the advantage of current depositor acceptance because it provides most savers witha reasonable level of account coverage in one institution. The vast majority of savings and transaction accounts easily fall within the protection afforded by the existing level of federal deposit insurance.

Reduction of this current level might result in a lowering of the stresses and strains the FSLIC is experiencing; however, it will not effectively result in a change of the amount of funds insured. Depositors in an effort to maintain the current level of insurance coverage will be prompted to divide their accounts among several institutions in order to achieve maximum insurance coverage. Such depositor splitting would result in a negligible net change in the dollar amount of insured funds.

Whether the potential advantages to reducing the level of federal deposit insurance coverage outweighs the likley adverse effects such a change would have is the dilemma presented for Congress' resolution.

8) Increased Disclosure.

Deciding what information to disclose to the public regarding an institution's operations, especially regarding any actual or potential problems it may be facing, requires a careful balancing of competing concerns and treatment on a case-by-case basis. On the one hand, the Bank Board recognizes the public's need for information about thrift institutions. On the other, the Board wishes to prevent the instability in a particular institution, or in the industry as a whole, that can result when information is disseminated but misinterpreted. In an effort to address both these concerns, the Board has drawn careful limits with respect to the disclosure of information to the public.

For savings and loan associations and savings banks that are subject to the Securities and Exchange Act of 1934 ("'34 Act"), a comprehensive disclosure regime requires full disclosure of material information concerning the institution to its stockholders and the investing public. (As of June 15, 1985, approximately 340 institutions are registered with the Bank

Board pursuant to the `34 Act.) The Bank Board vigorously enforces the disclosure requirements of its `34 Act jurisdiction. The Board has been successful in obtaining compliance with the `34 Act requirements through the use of informal directives, supervisory agreements, and cease-and-desist orders. It has been virtually unnecessary to resort to civil injunction action in order to achieve compliance. These enforcement proceedings are not kept confidential, and it has been the Board`s general practice to disclose publicly the results of enforcement actions taken with regard to compliance with the `34 Act, as well as the Board`s stock-conversion regulation and Change in Control Act. In addition, the Board`s Washington, D.C., staff works with the Board`s network of supervisory agents to verify the accuracy of information disclosed in required reports to the Board. Thus, with respect to `34 Act institutions, the Board maintains an active program to insure that institutions make appropriate and timely public disclosures of material information enforced by a vigorous compliance program, which includes publicity of enforcement action taken.

The Bank Board does not generally disclose information concerning cease-and-desist or removal/prohibition proceedings unrelated to its `34 Act jurisdiction. Instead, these administrative proceedings are confidential unless the Board determines, after considering the views of the party afforded a hearing, that disclosure is in the public interest.

With regard to general financial data, the Board requires all institutions it supervises to submit, on a quarterly basis, a complete balance sheet and income and expense statement, including data on brokered funds, types of deposits and borrowings, outstanding mortgage loans, and composition of net worth. The Board previously required this submission semi-annually but increased the frequency of reporting to quarterly in March 1984. As in the past, the Board publishes this information in the aggregate. In addition, although the Board does not make all this data publicly available with regard to each institution, the public can obtain much of it for a small processing fee.

For the following reasons, however, the Board believes that the likely adverse effects of applying a full disclosure policy to the thrift industry would far outweigh any potential benefits.

First, broad disclosure of enforcement orders would likely lead to misunderstandings that would erode public confidence in the institution affected by an order, whether or not the order related to the institution's financial health. Many types of enforcement orders are unrelated to a thrift's soundness.

Examples of such orders include those relating to the stock-conversion or proxy rules, Regulation Z disclosures to borrowers, and accounting and bookkeeping requirements for loans. Yet, consumers could easily misinterpret such an order as a sign of an institution's ill health. When consumers act on such misinterpretations by withdrawing their funds, public confidence in the institution is needlessly lost, and the thrift suffers financially from the withdrawals.

Even when an enforcement order does concern activity that relates to a thrift's viability, the existence of the order usually means that the Bank Board has already taken effective steps to protect the institution from further harm. In such circumstances, the consumer with savings at or below the maximum amount for federal insurance coverage is insulated from loss not only by the insurance fund but by the remedial effect of the enforcement order. Ironically, publication of the remedial order may trigger a loss of public confidence in an institution at the very moment when it has begun to solve its problems. Having misinterpreted the significance of an enforcement order, consumers may shun not only the affected thrift but other thrifts in the same state, region, or market area as well. Thus, in addition to undermining the remedial purpose of an enforcement proceeding, such a misinterpretation could threaten the stability of the industry and the insurance fund to the detriment of both institutions and their depositors.

Second, a broad disclosure policy would likely discourage institutions from entering into enforcement orders by consent. Knowing that adverse publicity will result no matter what course of action it takes, an institution and its board of directors may well decide that they have little to lose by choosing to engage in a protracted enforcement proceeding. Of course, this result would further delay beneficial remedial action and would tax the agency's limited enforcement resources. In addition, it runs counter to one goal of deregulation, the encouragement of voluntary compliance with applicable rules and requirements whenever possible.

Finally, without the assurance of confidential treatment, many institutions might be hesitant to cooperate fully with the examiners in providing the information necessary to accurately assess and understand the status of such institutions. Broad disclosure will certainly encourage the industry to take a more adversarial posture with regard to its regulators. In such a difficult environment, the free flow of information will be stifled. As a result, the examination process will be slower and much more difficult, rendering the early detection and resolution of an institution's financial problems much less likely.

The Board therefore believes that it should continue to address disclosure issues on a case-by-case basis so that it may carefully balance the sometimes conflicting goals of market discipline through public disclosure versus maintenance of the public confidence in the depository system through effective supervisory and enforcement actions.

9) Intensified Supervision

In response to the growing pressures within the thrift industry that too often erupt into unsafe or unsound practices, the Bank Board, in 1984, directed the Federal Home Loan Banks to increase the number of professional supervisory personnel at each FHLBank.

In addition, the FHLBanks have been under instruction by the Board to strengthen their supervisory staffs. By December 31, 1985, it is anticipated that the supervisory and applications professional staffs of the FHLBanks will have approximately doubled to 381 persons.

On April 12, 1984, the Board issued a memorandum of directives to its supervisory agents to take firm corrective action in response to every report of substantial problems at insured institutions revealed by Board examiners. In particular, the Board noted the need to address problems with deficient recordkeeping by using supervisory agreements or cease-and-desist orders, and directed that institutions exhibiting excessive growth were to be the subject of immediate on-site evaluations.

This forceful approach to supervision and enforcement resulted in the number of formal enforcement actions and investigative proceedings increasing significantly in 1984, and to date in 1985. As the FHLBanks have now hired the additional supervisory personnel as directed by the Board, and are in the process of hiring additional examiners, the number of requests coming to the Enforcement Division of the Office of General Counsel also has increased significantly and will continue to increase in the forseeable future. This trend was assured on August 9, 1985, when the Board again issued directives to the supervisory personnel at the FHLBanks, stressing the need to pursue forceful supervisory and enforcement actions of all kinds, and again on August 23, 1985, when the Board directed that all material violations of supervisory agreements, laws, and regulations be reported directly to the Enforcement Division for its consideration of formal enforcement actions.

10) Increased Examiner Staffing and Compensation

The field examination force of the Bank Board's Office of Examinations and Supervision (OES) was transferred to the twelve FHLBanks on July 8, 1985. In effect, this removed 750 field examiners from the existing pay and classification constraints imposed on the Bank Board to the more flexible Government-sponsored enterprise status of the FHLBank System.

This transfer was effected after considerable study by the staffs of the Board and the FHLBanks, as well as consultations with members of the current Administration, leaders of the Senate and the House of Representatives, representatives of the savings institutions industry, and various individuals in the private sector.

Adequate examination and supervision are the front line of defense for the FSLIC. While the examiners were under Civil Service, their number was restricted by budgetary constraints and their salary levels were not competitive with the private sector. The turnover rate for examiners in some districts had been as high as 28 percent, thus leading to a constantly changing examination staff of limited average experience. Additionally, hearings by the House Committee on Government Operations, resulting from the failure of the Empire Savings and Loan Association of Mesquite, Texas, indicated that there was a lack of coordination between the examiners in the Ninth FHLBank District and the supervisory agents of that District - a situation which inhibited effective supervision. Consequently, the Board decided to provide both flexibility in hiring of the needed number and quality of examiners and to improve the requisite coordination of examination and supervisory activities by transferring the examining staffs to the FHLBanks. This was done as of July 8, 1985, and now both the examining and supervisory functions are under the direct control of the FHLBanks Presidents in their role of Board-designated Primary Supervisory Agents.

The efficacy of this change for the examination staff is already evident. The number of examiners is increasing rapidly. Of the 860 persons transferred on July 8, 1985, 747 were professional staff. The professional staff as of August 31, 1985 was 835 and is projected to be 1,006 by December 31, 1985. This represents an increase of 259 examiners, or 35 percent during the six months ending December 31, 1985. Further increases of approximately 500 examiners will be undertaken in calendar year 1986. In addition to the fairly dramatic numerical increases, reports from the Directors of Examinations have indicated that the ability to offer competitive starting salaries has resulted in attracting highly qualified candidates with strong backgrounds in accounting and finance.

11) Market Value Accounting.

Application of market value accounting to the financial industry has been a source of controversy within both the thrift industry and the accounting profession because of the difficulty of assessing the current or market value of assets not actively traded and its direct conflict with the principle of historical cost. Market value accounting requires "marking to market" the value of an institution's loan and investment portfolio on a periodic basis and realizing either the gain or loss against net worth. In its simplest application and for purposes of illustration, market value accounting would require an institution with a thirty year mortgage loan originated several years ago at a contract and market interest rate of nine percent to be "marked to market." Under this concept, the mortgage loan would be discounted to reflect the change in value that the market would place on the difference between the nine percent original rate of return and the current prevailing interest rate for a similar mortgage loan.

Advocates of this method of accounting argue that a truer picture of the value of the institution results from use of market value accounting. However, market value accounting is in direct contradiction with the historical cost principle of the Generally Accepted Accounting Principles ("GAAP"). Additionally, there exists a continuing debate over whether long term assets, such as nonconforming mortgages without an actively trading secondary market, should be treated as long term investments with an acceptable, though not current, rate of return, or treated as marketable assets to be "marked to market."

Because of the continuing debate over the appropriate use of this method of accounting, the administrative complexity of maintaining and updating books and records, and the difficulty of accurately assigning value to assets with no active market in which to trade or receive market value, the Board is of the opinion that market value accounting should not be used for thrift institutions at this time. As the theory evolves, it may be appropriate to apply such method to thrift institutions eventually; however, the current level of understanding does not support the present application of market value accounting to thrift institutions.

12) Private Deposit Insurance.

The Subcommittee also has requested comment on the Board's opinion on the role of private deposit insurance. As evidenced by recent events, it appears that private deposit insurance plans are unworkable in today's environment. Public confidence in such plans has been severely eroded due to events in Maryland and Ohio. The Bank Board believes that universal federal deposit insurance is essential to maintain a sound and stable financial system in a volatile deregulated environment.

One of the reasons federal deposit insurance was created is that many depositors cannot distinguish between sound and unsound depository institutions. In assessing degrees of financial safety, the full faith and credit of the United States offers the best credit risk, and accordingly, the best guide to institutional soundness for protection of the average depositor. Confusion over the nature of private insurance funds, mistakenly believed by some to be state-backed or backed by the full faith and credit of the United States, detracts from the ability of the public to distinguish between sound and unsound institutions. The recent crises demonstrate that a person who places money in a depository institution ought to know the true nature of the insurance backing that institution as well as the regulatory apparatus governing that insurance.

In the Board's view, the public would be protected best by requiring federal insurance for all depository institutions. As the events in Ohio and Maryland have vividly reminded us, there appears to be no adequate substitute in the minds of depositors for federal deposit insurance.

13) Brokered Deposit Restrictions

H.R. 1680 would permit the Bank Board to establish classes of insured accounts and to insure only those classes appropriate for insurance by a federal agency. We believe this enhancement of our existing statutory authority under the National Housing Act would further strengthen the FSLIC and preserve the integrity of the thrift regulatory structure. By providing such authority, the bill would give the Bank Board the authority to prevent the diversion of deposit insurance resources to activities such as deposit brokering.

APPENDIX B

FIELD EXAMINER STAFFING, TURNOVER AND SALARY STRUCTURE

1) The Subcommittee has requested that we provide yearly figures from 1975 to the present regarding examiner staffing levels, examiner turnover rates, and minimum and maximum salaries paid to examiners (nominal and adjusted for changes in the Consumer Price Index).

STAFFING LEVELS

FISCAL YEAR		
	1975	633
	1976	632
	1977	633
	1978	739
	1979	728
	1980	728
	1981	742
	1982	721
	1983	702
	1984	690
	1985	679

NOTE: Staffing levels include examiners and first-level supervisors allocated for each fiscal year.

TURNOVER RATE

FISCAL YEAR		
	1981	10.4%
	1982	10.2%
	1983	11.7%
	1984	16.1%
	1985	14.0%

NOTE: Figures on the turnover rate from 1975 to 1980 are not available.

SALARIES PAID TO FIELD EXAMINERS

	Minimum (GS-5/1)	Maximum (GS-12/10)
1975	$ 8,925	$25,200
1976	9,303	26,571
1977	9,959	28,444
1978	10,507	30,017
1979	11,243	32,110
1980	12,266	35,033
1981	12,854	36,723

1982	13,369	38,185
1983	Same as 1982 - no cost of living adjustment	
1984	13,903	39,711
1985	14,390	41,105

2) Optimal Staffing Pattern and Compensation Rates

During the past year, the Board continued to experience problems which hampered its ability to staff the agency with sufficient numbers of employees with appropriate skill levels. The most significant indicator of these problems is the agency's turnover rate of over 27% agency-wide and 33% turnover for the FSLIC. This rate is in sharp contrast with the government turnover rate of 11.8%. The volatile state of the industry has served to highlight the Board's urgent need to increase its capability to manage staffing with greater flexibility and it is clear that we need more than an increase in staff or minor adjustments in our staffing authorities in order to cope with all of the thrift industry's needs.

Many factors have contributed to this severe staffing problem but the restrictions in the Classification Act are clearly the most significant. This Act imposes several restrictions in fixing the compensation of the workforce which impede our ability to attract and compete for the level of talent we need in order to respond to the pressing issues of the savings institution industry. If we were exempt from the Classification Act, we would enjoy several flexibilities that would significantly alleviate our recruiting and staffing problems.

The Board would have the freedom to set salaries at rates commensurate with our judgment of candidates' skills, rather than at the minimum rate of the pay scale as the Act currently requires. While we would not abandon use of the pay scale and ranges of the General Schedule Rates, we would have the freedom to appoint individuals at rates beyond the minimum step which would greatly enhance our flexibility to attract talented and highly skilled candidates. Second, the Board would have the discretion to set pay differentials within the General Schedule Pay Rates based on geographic location for all positions. Third, the Board would have the authority to develop single agency classification standards which would reflect the complexity and specialized skills of our workforce. Finally, the Board would have the authority to promote employees to salary levels commensurate with their contributions and level of work, rather than to pre-established, narrowly defined increases.

Chairman St Germain. Thank you, Mr. Gray.

Mr. Gray, when Mr. Stearns, who heads up the FSLIC, the insurance fund, testified before us a few weeks back, he stated that the funds stood at $6.6 billion. On page 8 of your statement, however, you say that today the usable—that is to say, the unobligated reserves of FSLIC—are at $3.2 billion.

I am told that under the management contracts and the operation that is now going on in California for which you are to be commended—and I am sure we will get into that in more detail later on—that you are also using income capital certificates that are also drawn against this $3.2 billion. What is the amount of those income capital certificates at the present time?

Mr. Gray. $523 million. But this figure will not further reduce the FSLIC's unobligated balance of $3.2 billion because all income capital certificate purchases have already been taken into account in calculating the $3.2 billion balance.

Chairman St Germain. $580 million for the 17 institutions now under it?

Mr. Gray. That is right.

Chairman St Germain. You anticipate how many more institutions in the State of California coming under this program?

Mr. Gray. I am not sure I can break it down for the State of California at the moment.

Chairman St Germain. Well, California and Texas. Let's add the two of those then.

Mr. Gray. At least another 30. Actually, over an extended period of time estimate approximately 70 throughout the country.

Chairman St Germain. Within the next 6 or 7 months, what do you think the amount of these income capital certificates is going to be?

Mr. Gray. Well, we can foresee the need for income capital certificates to bring these institutions above zero net worth in the amount of between $1 and $1.5 billion.

Chairman St Germain. One and one-half billion dollars? So if you take that away from the $3.2 billion, you are down to $1.5 to $2 billion. That is the insuring fund.

Mr. Gray. Yes. That would be true except that we, of course, will have additional special assessments, I anticipate, as well as the regular premiums.

Chairman St Germain. The fact of the matter is that I think the time has come to tell it as it is. We had academicians up here who have done very thorough studies and are telling us about the size of the FSLIC insuring funds. I said to myself, my goodness gracious, where are they getting their numbers? They were so high. As a matter of fact, the fund could potentially be down to between $1.5 and $2 billion, with a draw of $750 million from the Treasury Department.

Mr. Gray. I suppose there could be scenarios in which that would be true.

Chairman St Germain. As I say, Mr. Gray, you know the industry and you and the fund need very special attention here and the time has come to stop painting rosy pictures, but to tell it as it is.

Now, it has come to my attention that under these management contracts and, as I say, I am very impressed by this, taking some of the best CEO's in the business, from around the country, and bringing them in, into California, I am impressed by the fact that these people have such a devotion to the savings and loan industry that they are going in and they are doing this, leaving their own institutions and dedicating themselves to assisting the Federal Home Loan Bank Board and FSLIC. But I am told—and this is factual—that one of the large associations now under a management contract had invested in a mushroom farm and a tire retreading company?

Mr. Gray. That is true.

Chairman St Germain. Did that signify they felt their savings and loan industry in California needed somewhat of a retreading operation, like we all went through in World War II? Is it true another formerly billion dollar association has several warehouses of new furniture and that the day after the former owners were fired, the new management asked if it was all right by the pilot of the association's plane to fly the former owners to Lake Arrowhead? I understand it was the first occasion your managers knew they even owned the airplane. Is that factual?

Mr. Gray. I am not sure.

Chairman St Germain. That was not a golden parachute, that was an actual parachute on the plane you had.

Mr. Gray. Yes. Sounds correct.

Chairman St Germain. Well, I think we are accurate. Now, several associations, I am advised, entered into net operating agreements for resort hotels. Now, under such agreement there is no cash-flow unless a profit is shown, and in these instances they are something with correspondingly low income.

As a consequence, no return on multimillion dollar loans is estimated for a 5-to-7-year period in the future. Notwithstanding permissive State law, are those not basic safety and soundness violations, Mr. Chairman—taking a chance you won't get any income for 5 to 7 years whatsoever?

Mr. Gray. Of course. Those are among the reasons why these institutions are now in management consignment programs.

Chairman St Germain. Am I correct that there also was a loan on recreational vehicle condos?.

Mr. Gray. Yes.

Chairman St Germain. Tied into that a fleet of boats?

Mr. Gray. Yes.

Chairman St Germain. To take the people from the RV condos to gamble where? In Nevada someplace?

Mr. Gray. Yes.

Chairman St Germain. Would you explain that one to us a little bit?

Mr. Gray. Well, the boats were used to take them to a gambling area across the river.

Chairman St Germain. But the S&L gave mortgages on the boats, as well as the recreational vehicle condos? It is the first time I have heard that RV's could be condo'ed.

Mr. Gray. That is my understanding.

Chairman St Germain. I will tell you. Is it any wonder, say, to the members of this committee, that we are in trouble here? I think we've got to take another very, very strong look at what the

States are permitting. I hope that our colleagues in those States that feel that they are doing the right thing will reconsider. I am hoping we will move H.R. 20, which indeed would address a good deal of this. H.R. 20 is now in the Rules Committee.

Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman.

I join with you and with Mr. Wylie in welcoming the Chairman of the Federal Home Loan Bank Board to the committee.

Mr. Gray, you have been serving as Chairman in one of the worst periods in the history of the savings and loan industry. You have been before this committee many times, you have been working hard for solutions, but the problem, it seems to me, and I would like the benefit of your thinking, is not getting any better, but is getting worse. We know that. The committee members that I have talked to are very concerned.

I have had an opportunity to read your statement in depth. We don't normally have the privilege around here of getting statements and having the time to read and tie-in just what is in the statements.

It is like the Gramm-Rudman bill. You vote on it, and the Members tell me they know what is in those pieces of legislation, I don't like to use the phrase, but, hell, they are just lying to themselves. We really don't know what is in it because we don't have the time to fully debate it. We don't have the time to get all of the facts.

Things are going right past you like there is a kind of emergency that we have to solve. All of these emergencies that we have not been solving, you know, are catching up with us.

If you can, I would like some specifics. What is it, in your opinion, that we must do right now to solve the insurance problem and how can it be accomplished? I mean, let's get to the bottom line.

Mr. GRAY. All right. I will take you along the bottom line.

We have at the moment $3.2 billion. Despite the infusion of $750 million through special assessments which the Bank Board has imposed on member FSLIC institutions, we have $3.2 billion in unobligated reserves.

Imagine, incidentally, had we not assessed those special premiums, we would be down to less than $2.5 billion in our unobligated reserves. In fact, I would say $2.6, $2.7 billion would represent the effective, usable reserves of the fund at this time to deal with problem cases.

We are talking about cases which come from a trillion-dollar industry in assets. With this being the case, and given the fact that approximately a tenth of the institutions in our industry are either insolvent or are projected to become insolvent within the next year, the assets of those institutions would be around $90 billion.

And imagine the rule of thumb when we are talking about the magnitude of bad assets that we have to deal with in these failed institutions. Imagine the fact that it generally costs anywhere between three and five times what it cost to resolve earning spread cases back in 1981 and 1982.

And I would point out here, incidentally, that we certainly hope that some 80 of those institutions could find resolution without assistance from the FSLIC.

I would point out that we are talking about roughly a tenth of the industry. Then you begin to see the magnitude of the problems that face us.

If we have insufficient capital at the insurance fund to deal with these kinds of problems, particularly the magnitude of these kinds of problems, it puts us in a position of frankly not being able to resolve these problems.

Mr. ANNUNZIO. I hate to interrupt you, but that is the very point I am making. There isn't a member of this committee, or yourself or other Board members, who don't realize the magnitude of the problem, you see.

Now, you are reciting the problem. I don't want to hear about the problem. I want to hear about a specific solution.

What do you suggest, what must we do, what must happen to solve this problem?

Mr. GRAY. All right. I have tried to go through in my testimony, Congressman, some of the few alternatives that we have to provide additional capital.

Now, one is to go to the taxpayers for money. That is something that I don't believe very many Members of Congress are prepared to do, and I understand that perfectly well and I am not advocating that myself, because we already have a substantial deficit to deal with and that is what Congress is struggling to deal with now.

Mr. ANNUNZIO. We have an enormous deficit, not merely a substantial one.

Mr. GRAY. If you assume that capital cannot come from the taxpayers, then you have only one other source, really, and that is from the industry.

You could say that you could prevail on the reserves of the Federal home loan banks, which would provide somewhere between $1½ to $1¾ billion. Those are reserves that are actually there and are not represented by the capital stock held by member institutions in the Federal home loan banks.

We have a very highly capitalized Federal Home Loan Bank System, but most of that is represented by the stockholdings of member institutions, and those institutions count that stock as an asset. So there you are talking about 1½ to 1¾ billion at the most if that alternative were to be exercised.

The other several alternatives that I have been able to think of and we at the Bank Board have been able to think of are, one, to increase our authority to impose special assessments.

Right now we have the authority, as it turns out, to increase assessments by one-eighth of 1 percent of deposits, and we have already exercised that in the first three quarters of this year. If we were to do it in four quarters of this year, it would produce a billion dollars. That is above and beyond the regular premium assessment which yields the fund approximately $600 to $650 million a year.

The only other alternative was one that has been discussed going back frankly to last year, This concept is the deposit setaside approach which was enacted by the Congress for the National Credit Union Administration and its fund. Under that concept, institutions are required to send 1 percent of their deposits to the insurance fund. They are held there as an asset until drawn down, and at such time as they are drawn down, they are expensed.

Those are the only alternatives—taxpayers, Federal Home Loan Bank System, and frankly, the other two representing member institutions—that I can think of to recapitalize this fund. Maybe there are other ways to do this.

We, of course, at the Bank Board do not print money. We can't wave magic wands and we are not experts in alchemy. So those are the only alternatives that I see to recapitalize the fund.

This is why I have emphasized the importance of recapitalizing the fund in order for us to have the resources to deal with the magnitude of these problems.

Mr. ANNUNZIO. Thank you, Mr. Chairman. My time has expired.

Chairman ST GERMAIN. Not yours, his.

Chairman Gray, I just want to make one thing clear: The institutions I mentioned involved in RV condos, tire retreading, mushroom farms, et cetera, are State-chartered institutions—State of California. Federally chartered institutions could not do that under your regulations.

Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

As a followup to that, we had a meeting with Chairman Gray and the minority members of the committee. It was a very good meeting, may I say, and I am convinced that you do have a problem vis-a-vis FSLIC, and I am as concerned as you are that we try to resolve the problem which I perceive that you have.

But you raised the question about the propriety of certain activities by State-chartered S&L's in California, Texas, and Florida in that meeting and the Chairman has brought up some more here this morning.

If these activities were truly harmful to the fund, couldn't you or your regulators have done something about it? Couldn't you have prohibited those State-chartered institutions from engaging in those pursuits?

Mr. GRAY. We, using the insurance regulations to deal with these kinds of problems, would find it very difficult unless there were a preemption of State law because those authorities are provided by State law to State-chartered institutions.

In California, a federally insured thrift can engage in any activity it wishes.

Now, Congressman, earlier this year, the Bank Board adopted a regulation which more than one-half of your colleagues in this body signed a resolution to derail, as I have suggested, which was very mild.

It merely established a threshold of 10 percent for direct investment, at which time we sought permission to look at the activities that these institutions wanted to engage in above and beyond the 10-percent threshold. We met a firestorm of opposition not only from individual thrift institutions but frankly from most all of the State regulators around this country, and we were accused at the time of doing in the dual banking system, which of course was not the case.

There is no way this could have done in the dual banking system. It was merely an opportunity to give us a review period to take a look at direct investments above threshold amounts tied to net worth.

Mr. Wylie. The point I want to make here is, you could preempt State law by regulation but you got considerable amount of resistance from Members from those States——

Mr. Gray. Right.

Mr. Wylie. Plus the thrift industry; isn't that a fact?

Mr. Gray. Right. Right.

Mr. Wylie. So what you are seeking here is some help, as I understand it——

Mr. Gray. Yes.

Mr. Wylie. From this Congress. And let us provide some form of uniform regulation. That is what it amounts to, isn't it?

Mr. Gray. One of the authorities that we requested is contained in section 4(e) of the House Banking Committee bill which would allow the Bank Board to establish a laundry list of activities which we believe, and this would be done through regulation, would constitute an improper incident to the operation of a thrift, the kinds of exotic activities that you are talking about.

Mr. Wylie. I think that is a question you will have to be prepared to answer, and I think you are responding, maybe not in the detail that you might have to, but I think the Bank Board does have the authority under regulation to preempt State laws in these instances and if they feel like there is some pressure on the fund or if the fund is being exposed unnecessarily through these activities of RV's and motor boats and other kinds of activity, that you could prevent that.

Mr. Gray. Well, one of the difficulties is that we have been in this deregulated operating environment for a relatively short period of time. When these kinds of activities come to the fore and losses take place when we institutions become insolvent, we find out about that, unfortunately, too late in the regulatory process.

I have, as you know, talked about oil well drilling, fast food restaurants, ethanol plants and the like.

Mr. Wylie. That is with repurchase agreements?

Mr. Gray. There are a number of things that I have cited which gave rise to concern to us at the Bank Board. If we use the insurance regulations to deal with these problems, we are subject to challenge in court. We have to show on a safety and soundness basis that this will have adverse consequences for the fund.

Mr. Wylie. I want to ask you about your 1-percent charge on deposits. The chairman and I have introduced a bill by request to help you in that regard, and as you mentioned, the thrift industry is opposed to it.

Mr. Levy testified to that fact. Mr. Elshoff, who is president of the Ohio Savings & Loan League, has written to me and said the Ohio Savings & Loan League is against it. The basis on which they are against it is that they say that the troubled institutions would have some of their assets removed at a time when they need them, and those which are in sound shape ought not to be penalized because of some of those in the industry that have done some of the things you have talked about here this morning.

What is your answer to that?

Mr. **Gray**. First of all, let me make it clear that the Bank Board has not requested this committee or any other committee to introduce legislation that would specify any particular kind of recapitalization program.

Our concern has been that the fund needs to be recapitalized. However, to respond to your question, it is very understandable in my mind that institutions that are well run and well capitalized would have severe problems with a deposit setaside proposal, particularly if it were drawn down quickly.

After all, that kind of drawdown would come right off of their net worth, and we are talking about heavy levels of net worth in the event of such a drawdown going right out the door from these institutions.

These are well-run institutions. They have worked very hard to accumulate healthy levels of capital and perhaps putting myself in their position, I would have very severe problems with a deposit setaside type of scheme if those deposits, counting as an asset at the beginning, were drawn down and expensed.

Another problem for these institutions is that the rules of the game changed in 1982 and the beginning of 1983 when deregulation occurred. As I have pointed out, we have a joint group insurance plan that covers all risk, not only for federally chartered institutions but State-chartered institutions.

This group insurance plan, and all group insurance plans that accommodate all of the risk and actual losses by their very nature have to be very well capitalized because they must absorb so much risk and so many losses.

So what we have is a group insurance plan that was not fashioned to deal in this kind of environment. For a half century it was able to deal effectively, but with the advent of the kind of deregulation we have seen in some States, the magnitude of that risk has increased enormously and all we have to do is look at California.

Chairman **St Germain**. Let's get back to Mr. Wylie's question. I am going to interrupt here because I think it is important to all of us.

Mr. **Gray**. Right.

Chairman **St Germain**. You have told us that large institutions, I mean the healthy institutions, have to realize it is group insurance. Now let's go to the ailing institutions. What does this do to them? Because they too have to come up with this.

Let's not kid each other. It is 1 percent. That is what you have been talking about. Tell us about them. How many institutions would this shut down automatically?

Mr. **Gray**. It could shut down some.

Chairman **St Germain**. Some? How many?

Mr. **Gray**. I can't tell you that.

Chairman **St Germain**. Could your very competent research staff come up with those numbers for us? Because we have to have those numbers before we can even consider requests of that type.

Mr. **Gray**. We will be happy to do that for the record.

[In response to the request of Chairman St Germain, the following information was submitted for the record by Mr. Gray:]

As of June 30, 1985, 88 FSLIC insured institutions were insolvent based on Regulatory Accounting Principles [RAP]. If these institutions were required to deposit 1 percent of insured accounts with the FSLIC and these deposits were immediately drawn down, then 102 additional institutions would become insolvent under RAP, or a total of 190 institutions.

Mr. Wylie. Thank you very much, Mr. Chairman. I appreciate your intervening.

I understand the bill hasn't actually been introduced yet. That is one of the questions we had about your proposal. But if we are going to shut down some institutions by imposing a 1-percent charge, I don't think we want to do that.

Mr. Gray. No.

Mr. Wylie. I don't think we want to, by legislation, shut down——

Mr. Gray. I would agree with you on that. I have tried to tell you that the range of options available for recapitalization of the fund are very limited and there are no easy answers. Every one of these is a wrenching problem.

I am advised by the Director of Policy and Economic Research, that the number could be somewhere in the neighborhood of 50 to 100 institutions, but I would not want to rely on these figures without a good deal more research. However, this would only happen if there is a drawdown and it would only happen to the extent that there was be a drawdown on the 1 percent.

Mr. Wylie. Mr. Chairman, I will get back to this but I know others are anxious to question Mr. Gray.

Chairman St Germain. Before I recognize Mr. Hubbard, remember what came up during my question that the fund now effectively could be down between $1.5 and $2 billion, so that drop may not be far from the future.

Mr. Hubbard.

Mr. Hubbard. Thank you, Mr. Chairman.

I too would like to express my appreciation to you, Chairman Gray, for appearing before our subcommittee and giving us this information. I congratulate you upon the excellent job that you have done as chairman, especially updating and modernizing the regulatory functions of the integral thrift system and upgrading the supervision capability.

I have visited, as a member of the Banking Committee, S&L's in Ohio, Maryland, and Kentucky, which have serious problems. My home State is Kentucky, and in my own district many of the S&L's are having difficulties. Officials meet with me from time to time in the district and here in Washington to discuss their problems.

I have also visited S&L's in your home State of California, which are doing extremely well. Some might argue, well, the economy is better in California than it is in western Kentucky.

I visited last week the Columbia Savings and Loan Association of Beverly Hills, CA. They have a tremendous operation there with Abraham Spiegel, the chairman of the board, and Tom Spiegel, the president and CEO.

To what do you attribute their success and the success of other California S&L's versus the problems that we have in Kentucky, Maryland, Ohio, and other States?

Mr. Gray. As a general rule, successful institutions have been ones that have been willing to operate prudently and to establish a sound management system to stick to their knitting which is fundamentally providing mortgage credit for housing.

Mr. HUBBARD. I can assure you that constituents of mine who are operating S&L's in my district would argue that they do too operate prudently and have sound management systems. But their status is probably lower versus what we saw in California.

Would you recommend some of my S&L's in western Kentucky try the same operation that Columbia in Beverly Hills does in the junk bond business or high-yield securities?

Mr. GRAY. They better really know what they are doing if they get into that business.

But let me say further that there are areas of our country that are frankly not beset by the problems that we see in California, Texas, and Florida. I am not trying to think of the situation in Kentucky. I don't have the impression that we have the kinds of problems in Kentucky that we do in some of these other States.

If I could characterize the problem, you might start on the upper west coast, do a swathing down to California, and then all the way across the Sun Belt to Florida. That is where most of our problems are coming from and most of our problems are occurring in the State-chartered institutions that have far more liberal operating authorities than those granted by Garn-St Germain.

Mr. HUBBARD. Is that one reason the California S&L's are doing so much better than other States, because they are State chartered?

Mr. GRAY. Well, when you look at the nature of the problem cases in California, one cannot or should not assume that all institutions in California are doing very well. Some are doing very well; others have been left on our doorstep. So it is a mixed bag.

Mr. HUBBARD. Are you familiar with Columbia Savings and Loan in Beverly Hills?

Mr. GRAY. Somewhat.

Chairman ST GERMAIN. Would the gentleman yield?

The chairman is familiar with Columbia Savings and Loan of Beverly Hills, if you would like to know a little about it.

Mr. HUBBARD. I was asking them last week, and I would ask you, or my chairman, to what do you attribute——

Chairman ST GERMAIN. Columbia S&L, I would say to our genial Member from Kentucky, was taken over by the father and son you mentioned. They brag about it, but what they don't mention is the fact that they have a godfather, the father, also, a big man in the junk bond business, who put a lot of capital the institution.

In addition to that, I would ask Chairman Gray or anybody on his very eminent staff to either confirm or deny this; I think Columbia primarily is a mortgage bank. They make the loans. They just keep turning these things over.

Remember we had a few votes on that, the percentage that you would keep. They essentially are mortgage bankers using FSLIC insurance.

Is that not correct, Chairman Gray?

Mr. GRAY. Well, Mr. Chairman, with all due respect, I don't think it is appropriate for me to be talking about any particular institution, particularly an ongoing institution, in this forum.

Chairman ST GERMAIN. It is not a typical S&L.

Mr. HUBBARD. The ones I have visited in my home State are in trouble. I visited one last week which is very successful. Let's put it that way.

I yield back the balance of my time and thank again the Chairman.

Chairman ST GERMAIN. I am happy to say that the thrifts in New England are doing fabulously well. That Boston regional bank is very, very fortunate.

Mr. Barnard.

Mr. BARNARD. Thank you very much.

Mr. Gray, today what would you say is the percentage of profitability among thrifts of institutions?

Mr. GRAY. Well——

Mr. BARNARD. Of the total number of savings and loans what would be the total number that are profitable?

Mr. GRAY. While this has not always been true of course, but today probably 8 out of 10.

Mr. BARNARD. In other words we have provisionally 80 percent——

Mr. GRAY. That is right.

Mr. BARNARD. Of the present savings and loans that are profitable?

Mr. GRAY. Yes.

Mr. BARNARD. That are profitable, OK.

So in other words, would you say then that the condition today is better, the same as, or worse than it was 1 year ago.

Mr. GRAY. Better.

Mr. BARNARD. It is better.

Mr. GRAY. It may be a different story for the FSLIC but for the institutions in this industry generally speaking overall, yes, it is better.

Mr. BARNARD. So prospects for survival in this next 12 months are better than they have been in the past 12 months, in other words? Prospects now?

Mr. GRAY. No, not for institutions that we project to become insolvent.

Mr. BARNARD. That is the 20 percent.

Mr. GRAY. Well, we——

Mr. BARNARD. That is the 20 percent not profitable right now.

Mr. GRAY. We either have insolvent cases or are projecting insolvent cases for about a 10th. So the others are right on the borderline.

Mr. BARNARD. A tenth would mean how many institutions then?

Mr. GRAY. Approaching 300.

Mr. BARNARD. 300 or 400. OK.

Now, is there any way you can tell us the amount of deposits and/or receipts that are represented by these 300?

Mr. GRAY. It depends on how you account for it but if you used RAP accounting it would be about $90 billion.

Mr. BARNARD. $90 million.

Mr. GRAY. Billion.

Mr. BARNARD. $90 billion.

Mr. GRAY. Yes.

Mr. Barnard. How much do you think you would recover from those institutions? In other words, what would be your estimated losses from that amount?

Mr. Gray. It's very difficult, Congressman.

Mr. Barnard. Ten percent?

Mr. Gray. It would probably cost more than that over time.

Mr. Barnard. Fifteen percent?

Mr. Gray. It would be somewhere in that range, 10 to 15 percent.

Mr. Barnard. So in other words, we are talking about—if it is $90 billion—we are talking around about something like $14 or $15 billion.

Mr. Gray. Could be. Might not.

Mr. Barnard. What I am trying to get to is the bottom line, of course. What do we really need? In other words, if we have $3.2 billion in reserves today, we have a possibility of getting—the special assessment will continue to bring in about $1 billion a year, right?

Mr. Gray. Yes.

Mr. Barnard. So therefore by next April, from $3.2 billion we should be up around $3.7 billion or $0.8 billion?

Mr. Gray. That would be the case only if we did nothing at the FSLIC.

Mr. Barnard. But the special assessment is still coming in?

Mr. Gray. Oh, yes. We have chosen to assess that special assessment on a quarterly basis.

Mr. Barnard. OK.

Mr. Gray. But if we were to continue, yes.

Mr. Barnard. So, I am trying to get up to about where we would be. So we are talking about $3.7 billion. We are normally $4 billion in cash reserves.

Mr. Gray. Not just from the special assessment. We have the regular premium, plus the investments that FSLIC makes. So you could say if you continued along that program it would be roughly $2 billion coming in each year.

Mr. Barnard. So we are still about $4 billion by next April. Why am I using April as a name? April is the time period when we will again be having to reextend Garn-St Germain—Mr. Chairman, I use that as a target date as to how fast this committee really needs to operate.

I agree with you, Mr. Gray, in all the other expressions you have made. We have a serious problem and we need to very adroitly approach it.

If I can say by next April we can be operating—the FSLIC can be operating between now and April on, say, about $4 billion in cash reserves——

Mr. Gray. That assumes, of course, that we do nothing with any of our problem?

Mr. Barnard. That is understandable. Don't you anticipate me. Let me just follow my own course.

Mr. Gray. All right.

Mr. Barnard. So then, what other powers do you have then to anticipate an emergency between now and that time? You could, of course, go to the Federal Home Loan Bank Board and tap their reserves? The regional Federal home loan bank boards.

Mr. **Gray**. Well, we could tap somewhere between \$1½ and \$1¾ billion.

Mr. **Barnard**. So we are up to now about \$6 billion?

Mr. **Gray**. Yes.

Mr. **Barnard**. OK. \$6 billion.

In addition to that, there is a liquidity provision in the law that you can also trigger, isn't that true?

Mr. **Gray**. That is true.

Mr. **Barnard**. I don't think we have discussed that this morning. Could you just briefly tell us what that is, how you would go about doing that, what you would do and how it would affect the institutions?

Mr. **Gray**. In terms of the FSLIC it would be the authority to call in 1 percent of deposits but it could only be used for liquidity purposes according to the legal reading I have gotten from our shop.

Mr. **Barnard**. What would be the value of them?

Mr. **Gray**. I don't see very much value from that.

Mr. **Barnard**. In other words, you could bring them into the reserves of the FSLIC?

Mr. **Gray**. Yes. It would provide investment income to the FSLIC if those deposits were used for investment purposes.

Mr. **Barnard**. So you already have that power in the law today?

Mr. **Gray**. Yes.

Mr. **Wylie**. Would the gentleman yield?

Mr. **Barnard**. Yes.

Mr. **Wylie**. I think he can ask each institution to deposit 1 percent of its deposits now, but you say they cannot be expensed? I don't understand what that means. How would that——

Mr. **Gray**. They cannot be drawn down to pay for problem cases.

Mr. **Barnard**. It only provides liquidity, Chalmers, for the fund. Liquidity meaning just what he said, he can invest to those and get income from it but he can't use it to write off any losses.

Chairman **St Germain**. Is that right?

Mr. **Wylie**. In your bill you would want additional authority to expense it or write off losses, is that right?

Mr. **Gray**. Well, we don't have a bill but if the deposit set aside an approach were to be exercised, then the FSLIC would have the ability at that time to draw down that deposit, set aside at whatever rate the FSLIC chose to draw it down.

Mr. **Wylie**. Thank you.

Mr. **Barnard**. My time has expired, but on the next round of questions, Mr. Chairman, I would like to explore this proposition that has been made to the Home Loan Bank Board on this 406(c) Corporation but I will wait until the next round to do that.

Thank you.

Chairman **St Germain**. I note that the members to my left arrived within minutes of each other, is it all right if I go by seniority?

Mr. McKinney.

Mr. **McKinney**. Thank you, Mr. Chairman.

It is good to see you here, Mr. Gray. What percentage of your 300 troubled institutions would you attribute to California and Texas?

Mr. **Gray**. I think it would be a guess now and I would be happy to provide that for the record. But it is a substantial amount.

[In response to the request of Congressman McKinney, the following information was submitted for the record by Mr. Gray:]

Currently, 11.3 percent of troubled institutions are in the state of California and 16.0 percent are in the state of Texas, for a total of 27.3 percent of the troubled institutions.

Mr. McKinney. You and I have gone around and around with this but let's go around it once again for the record. I find it difficult to believe that we sit here discussing a dual banking system State and Federal, when the Federal taxpayer is the one underwriting the whole system. Chairman Gray has given us some incredible examples—but I come from puritan ethical Connecticut and we live with a hand to steady habits.

I don't know why my depositors are paying more and more in service fees because their insurance premiums have been rising because State legislatures are—as I have used the statement before and I will use it again—certifiably insane in a few States when it comes to banking.

I have been watching on a daily basis the Maryland song and dance now going on in Annapolis in the chambers, and that is fine.

Maryland is, regardless of what the politicians tell us, going to end up eating about $100 million in losses which doesn't make anybody happy but that is fine, that is their problem.

It is not the taxpayers of the State of Connecticut or Rhode Island or Chicago.

Is there no mechanism you can use to just cut them off? What do we do, cut them off from Federal insurance, develop risk-related insurance, or not insure parts of their activities?

Mr. Gray. It is unfortunate that in retrospect we have to revisit this issue which you and I have been talking about over time. I have been talking about the need to better underwrite the risk of this fund for almost 2 years. I have been talking about horrendous examples of imprudence and gambling on the FSLIC by some institutions who didn't have to resort to the kind of investment instruments and the strategy they chose to undertake.

But they were allowed to do that under State legislation provided by States that will never have to pick up a penny of these losses.

Mr. McKinney. Sitting right in that very chair where you are sitting, Felix Rohatyhn was asked why he didn't invest Big Mac in REPO's or junk bonds because they paid more and his answer was very short and to the point, "If they are so darn good, why do they pay so much?" Yet we see California banks loading up on these things. I have problems with this because the two biggest amalgamators, sellers, underwriters, live in my district, but there is nothing you can do at the moment in other words to—without some sort of legislation?

Mr. Gray. In all honesty given the fact that more than half the Members of the House of Representatives had such a severe problem as expressed in a resolution with the very mild regulation that we proposed earlier this year, I wonder in my own mind whether the Bank Board as an agency trying to deal with these problems, could possibly accommodate the kind of political pressure that would go beyond that.

Mr. McKinney. Perhaps the fact——

Mr. Barnard. Would the gentleman yield?

Mr. McKinney. Yes.

Mr. Barnard. Mr. Chairman, let me ask you this question, from those same Members of Congress, how many complaints have you had from the operation that you have put in operation? You have had very few complaints.

Mr. Gray. Once done, no complaints.

Mr. Barnard. I am one that was very critical of what you did back in March and I really felt that Congress should have had an opportunity to review your regulations before you did them but I would compliment you now on the fact that you handled it in a very, very modest way and you have not impaled the industry.

But I want to say though that—this came up three times this morning and I thought I heard it long enough—but you have not heard from Members of Congress as to your handling of this matter.

Mr. Gray. That is true.

Mr. Barnard. Thank you.

Mr. McKinney. I would just simply say that perhaps conditions may have changed in Maryland because luckily it is next door to Washington and everybody is getting the Maryland news while flipping through the paper while enjoying their morning Post toasties and perhaps there may be a little more concern spreading throughout the brotherhood. I know that probably the opinions in Ohio have changed though I certainly wouldn't speak for my Ohio friends.

One of the things that really concerns me is that savings and loans today are more profitable than they have ever been as I understand it.

Mr. Gray. Yes.

Mr. Barnard. But there is a tremendous amount of confusion in the Congress, I think, and out there on the street between receipts and profitability, and I would hope that somehow or other the public as well as my colleagues could be sort of educated to the fact that profits are great and savings and loans they continue at a high rate you probably stave off some disasters but the real problem is receipts, isn't it, bad investments?

Mr. Gray. Yes, it is.

Mr. McKinney. My time has expired, but I would like to ask this one last question. Is it true that FDIC, in a collapse situation, has a loss on receipts in a commercial institution in the neighborhood of 5 to 9 percent while FSLIC, because of the nature of these wild card investments such as the chairman discussed most aptly, probably has a losses ratio of 20 to 25?

Mr. Gray. At present the cost of resolving problem institutions is between three to five times as great as the earnings spread costs which were around 4 to 5 percent back in 1981 and 1982. So you are talking about 15-20 percent.

Mr. McKinney. Thank you very much.

My time is up.

Chairman St Germain. Well, isn't it a factor that they are carrying those mortgages, like 5- or 6-percent mortgages at full value?

Mr. Gray. Part of the problem, yes.

Chairman St Germain. When you sell the mortgages on the open market, you will not get a hundred percent return. You will get substantially less.

Mr. Gray. Right.

Chairman St Germain. I didn't hear you say it, but weren't you in the tire business?

Mr. McKinney. Yes, and I got out in a hurry.

Chairman St Germain. Mrs. Roukema.

Mrs. Roukema. Thank you, Mr. Chairman.

I would like to say that the comments and observations of my colleague from Connecticut reflect my feelings most correctly with respect to regulations.

As one Member I wish that the Bank Board had moved more aggressively in the regulatory area and I hope that you will. I don't think that waiting for legislation precludes action now, does it or does it not, Mr. Gray?

Mr. Gray. Depends on what kind of action you are talking about.

Mrs. Roukema. I am talking about regulatory action.

Mr. Gray. We have taken a lot of regulatory action, to the extent we have been accused of being gross reregulators.

Mrs. Roukema. Well, I don't think you can move too aggressively in this particular area.

Mr. Gray. Thank you.

Mrs. Roukema. With respect to another statement that you have made, I repeat it only for the opportunity to give you an opportunity to respond to some statements made by one of the academicians who appeared previously before this committee and I would like to hear your reaction to this.

In your statement on page 16, you say, and I quote, "Our evidence indicates very clearly that direct equity investments are in fact more risky than debt instruments." This is something that both the chairman and Mr. McKinney referred to or alluded to earlier. It is at the heart of this issue about the Texas and California banks.

However, a Professor Benston of the University of Rochester has testified before this committee as to a study he has conducted and he concludes that direct investments have not been a major cause of thrift failures.

I would not want that testimony to go unchallenged by you and I would like to have your reaction.

Would you care to comment on that, the Benston work?

Mr. Gray. Well, I cannot in all honesty have any respect for that study because I think that it may have resulted from perhaps high fees paid, I don't know. But I think that it is totally devoid of realism.

We have looked at this now for months and months and all you need to do is to go to California and several other States and look at the problems which have resulted from this kind of activity and the answer will be before you.

Now the fact of the matter is that many of these direct investments were misclassified as acquisition, development, and construction loans, and that factor was apparently not taken into account by Professor Benston. But if you did take that into account, I think that his conclusions could have only come out very differently from the way they did.

Mrs. **Roukema**. Thank you.

Thank you, Mr. Chairman.

I yield back the balance of my time.

Chairman **St Germain**. I would like to follow up on your question, if you would yield to me.

Mrs. **Roukema**. Please do.

Chairman **St Germain**. The Benston report, I think it was financed by Lincoln S&L. A California S&L company, and promptly endorsed by the National Council of Savings Institutions.

Mr. **Gray**. Mr. Chairman, I am not sure.

Chairman **St Germain**. Now the National Council is the one that is headed by a former colleague of ours, John Rousselot, a very delightful gentleman who spent many years on this committee and who happens to be from the State of California.

The National Council primarily consists of the large institutions, is that not correct? Many of the S&L's belong to the National League and the United States League, but the National Council has the biggest, right?

Mr. **Gray**. I think many of them are big ones, yes.

Chairman **St Germain**. Let me ask you this, Butterfield Savings and Loan, do you remember that?

Mr. **Gray**. Right.

Chairman **St Germain**. They were one of the leaders in the fight against your regs; right?

Mr. **Gray**. Yes.

Chairman **St Germain**. Tell us about Butterfield. Where is it now?

Mr. **Gray**. Butterfield is insolvent.

Chairman **St Germain**. It is caput; isn't it?

Mr. **Gray**. Yes.

Chairman **St Germain**. Down the tubes. It is the S&L, Mrs. Roukema, in the lead fighting the Chairman's regs that sought to bring a little sanity to direct investment in California.

Mrs. **Roukema**. I certainly appreciate the chairman's comments and the comments of Mr. Gray. It would have been unfortunate had Mr. Benson's study gone unchallenged here.

Chairman **St Germain**. I don't think it went unchallenged, I think Chairman Gray was very direct in his reply.

Mrs. **Roukema**. No, I appreciate that. Thank you very much.

Mr. **Gray**. You are welcome.

Chairman **St Germain**. Let me ask you this, Mr. Chairman, does the administration support the 1-percent FSLIC recapitalization plan that you have presented in your testimony today?

Mr. **Gray**. I can't tell you, Mr. Chairman.

Chairman **St Germain**. Does the administration support the 406 corporation plan?

Mr. **Gray**. Let's put it this way, we are currently studying an application that was presented to us by the organizers. What the administration's position would be, whether it be OMB or the Treasury, I just don't know.

Chairman **St Germain**. Let me ask you this, Chairman Gray, because I want to yield to the other members who would like to ask questions, what suggestions has the administration, either Treasury or OMB, given the Federal Home Loan Bank Board in its dilemma here—let's not kid ourselves, you have a tough job, Chairman Gray, you are doing well, but you have a tough job. What suggestions, intelligence, whatever, have you received from the administration, albeit Treasury or OMB in this area?

Mr. Gray. Well, Mr. Chairman, we are an independent regulatory agency and we do meet with representatives of Treasury from time to time. They have asked questions but I have not gained from those meetings, and I have not met with all the representatives from the various Departments in the administration.

Chairman St Germain. Do you think that OMB and Treasury are aware of the plight of the savings and loans in this Nation of ours and particularly Federal savings and loans insurance corporations, insured by the FSLIC? Do you think they are unaware of your plight?

Mr. Gray. They have certainly been among the people we have talked to, and they cannot be unaware of the problems.

Mr. Wylie. Would the Chairman yield?

Chairman St Germain. Sure.

Mr. Wylie. I have been led to believe, Mr. Chairman, and I again think we ought to have somebody from Treasury up here to say this, that the administration is ready to support your recapitalization proposal but that is something that should come from them.

Chairman St Germain. Mr. McKinney.

Mr. McKinney. Just to follow through, Mr. Chairman, could I ask a question?

Chairman St Germain. Certainly.

Mr. McKinney. As an independent agency so to speak within the definition of the law and as paid for by those insured, why is OMB monkeying around in your store so much? I just wrote a letter to the editor of the New York Times and blasted him, defending you.

I hope it gets published because I state that if OMB would keep their fingers out of your business you would be able to do things a little better.

Mr. Gray. Well, let me say that OMB has had its oversight responsibilities over the Federal Home Loan Bank Board for, I think, many years and they take their oversight seriously, as they ought to.

There are times, of course, when we try to work out our differences and there are various degrees of success and this would not be unique to the Bank Board's relationships with the OMB. They have many, many Departments around the Government that they have oversight over but we have made a very real effort over time to work very closely with the people at OMB to try to resolve our differences and obtain the support we need.

Chairman St Germain. Chairman Gray, you can't say this but some of us can, we are aware of the handcuffs that sometimes are placed on you, and I am not asking you to comment.

Mr. Annunzio.

Mr. Annunzio. Thank you, Mr. Chairman.

I would like to read on page 11 of your statement, and this is the point I have been trying to make. You say "the problems we face"—and they are well stated, beautifully stated—"at the FSLIC, have their origins in the excesses of 1983 and 1984 when industry growth was fueled by high cost insured brokered funds and jumbo certificates of deposits."

You really state the problem. "Deposit deregulation, that is to say, removal of controls on rates of interest which could be paid to depositors—was and is the law of the land." As I warned repeatedly—these are your words—"in the late 1983 and 1984 period, the fast receipt growth of too many institutions on too little real cap mainfested itself in too many poorly underwritten loans at and excessively risky investments."

I think that is the crux of the entire problem. We have had those problems in Chicago. I wanted to say to you publicly that we have had turmoil, we have had all kinds of excitement in Chicago. Two of our largest thrift institutions bordered on going under and all the rest.

You came into our city and restored some calm and peace at First Federal and I think things are going along fine. I hope it's not going along getting any worse. That is because you acted aggressively. I realized this morning in the testimony that it is very difficult for you at this time maybe to act aggressively, but I know you can act and that you do have the ability and you can come forward.

There are two propositions the chairman stated, and we were trying to get an administration position. We are all aware of this problem. What we are looking for are solutions. That led you to come up with an answer.

I think that—I don't want to argue with my Republican friends—Gramm-Latta, supply-side economics—the sooner we all admit it was a failure the better off we are going to be. They were going to increase jobs and so forth and so on, but the revenue just wasn't there and we face these huge deficits of $200 billion a year. Deficits are created when you don't collect the money, you don't have it so it is a deficit.

We are now up to over $2 trillion. Now we come with this Gramm-Rudman and you better tell us something about how that affects your agency—and it does because it has limitations and so forth. It does.

Mr. Chairman, I appreciate that the good Chairman of the Federal Home Loan Bank Board is here this morning. I know he is suggesting 1 percent for that new insurance fund and the 406, the new corporation situation. But we better do something, the administration and this committee. I am not speaking as a Democrat, I am not speaking as a Republican, but I do know that in April of next year we better have an answer because 20 percent of these savings and loans are in very, very serious trouble.

I don't want to hear any more about how we got there. We are there and we are sinking fast.

What I want to do is get help on a program that will get us on board; that is going to save this system because it is a good system.

Mr. GRAY. Right.

Mr. ANNUNZIO. And just one thing, I heard testimony from the National Credit Union Administration. Their insurance fund is going along beautifully.

Mr. GRAY. Yes.

Mr. Annunzio. Why is that? Why can't you do the same thing?

Mr. Gray. Perhaps because I regulate a different industry.

Chairman St Germain. If the gentleman will yield, as I recall it, they were not able to make home mortgages until 1978. As a result thereof, their portfolios are not loaded down with those low-yielding mortgages. That is one of the advantages they have had.

Mr. Gray. Absolutely.

Chairman St Germain. It wasn't brought up when they testified.

Mr. Annunzio. I thank my chairman for his contribution.

Again, I am back where I started from. I learn what causes these problems. They didn't have mortgages, you see, so they are in pretty good shape.

I appreciate that. I want to know that but I think what we better all start looking for are some solutions to these problems. We cannot have a repetition in Chicago like we had a couple years ago. What is going on in Maryland, what is going on in Ohio, and we will find that in other States.

My time is up. I deeply appreciate you being with us this morning, and the help of you and your staff with this committee. If you can get your thinking cap on we better come up with an answer.

Mr. Gray. Thank you very much, Congressman.

Chairman St Germain. I say to the gentleman from Chicago, if he would wait 1 second, that he is absolutely correct. We have to look for a solution to the plight of the fund, but we cannot ignore the causes either, because if you don't cure—if you don't do away with the cause of this illness, then even if you throw more money in the deal, the illness will continue and you will just throw good money after bad.

That is why we have to go on both tracks here.

Mr. Gray, one quickie. Your staff, examiner staff went from 742 in 1981 to its current level of 679. This despite the fact that the problems have just gone up astronomically.

Was this reduction due to a policy reflected in the actions of the Office of Management and Budget, sometimes known as OMB?

Mr. Gray. Well, Mr. Chairman——

Chairman St Germain. Tell the truth now.

Mr. Gray. We do operate under budget constraints. We do operate under salary-setting constraints.

Chairman St Germain. Who sets those? Doesn't OMB set that policy?

Mr. Gray. Yes.

Chairman St Germain. So the answer is—yes? That is why you want to transfer them to the regional banks.

Mr. Gray. That is true.

Chairman St Germain. Mr. Wylie.

Mr. Wylie. Thank you.

I would say in response to what Mr. Annunzio, the gentleman from Illinois, said a little while ago on the insurance account, the credit union was behind that action. In the case of the thrift industry, the thrift industry opposed a similar proposal, however. That made it a little more difficult.

I wanted to clear up something on this 1-percent recapitalization that you are talking about. I have the present statute in front of me now here. In this I don't really see any restriction on it. The gentleman from Georgia mentioned that you have the authority to impose this 1-percent recapitalization against each institution's total deposits, but the gentleman from Georgia says you cannot spend it.

This language in the statute is fairly clear and specific, and it says, "the insured institutions shall make such deposits in the corporation as may from time to time be required by call of the Federal Home Loan Bank Board."

There isn't any limiting language as far as I can see. As a matter of fact, the legislative history indicates that the chairman of the Senate Banking Committee at that time said that this was to provide the Federal Savings and Loan Insurance Corporation with cash deposits up to approximately $1 billion to provide liquidity to the insurance corporation fund, and so I am a little confused as to——

Mr. **Gray**. It would provide liquidity to the extent of the deposits on hand. But those deposits apparently cannot be used and expensed to pay down losses, according to my lawyer, according to the legislative history and according to the efforts of our legal staff to look at this issue.

Mr. **Barnard**. Will the gentleman yield.

Mr. **Wylie**. I will be glad to yield.

Mr. **Barnard**. I have the legislative history here that was in the Senate report, if I can read that to you. I would like to clarify.

Mr. **Wylie**. Please do.

Mr. **Barnard**. I will read the introduction, this provision was included in order to make available additional financial resources for the Corporation within the traditional framework through which the industry has financed the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation by premiums and assessments on insured institutions, and has built up a reserve fund which now amounts to more than $1.3 billion.

Now, the new provision would provide additional liquidity for the Corporation. It would give standby authority for use if the insurance corporation's liquidity falls below a reasonable level. In this connection, the committee noted the distinction between short-run pressures on liquidity which this proposal is designed to meet, and adequacy of reserve fund to bear ultimate losses as to which the committee discerned no problem.

It is believed that there would ordinarily be no need to require any deposits as long as the corporation's resources in the form of cash and Government obligations are not below 1 percent of insured liabilities.

But it goes on to state, however——

Mr. **Wylie**. That part you just read doesn't say they cannot spend it.

Mr. **Barnard**. They can only use it as liquidity, meaning by that they cannot use it to pay off depositors.

Mr. **Wylie**. I don't understand that. It is not liquid if they cannot use it.

Chairman **St Germain**. Would you be kind enough to identify yourself, please, for the world at large, and particularly for the reporter.

Mr. **Raiden**. Yes, Mr. Chairman.

Norman H. Raiden, General Counsel, Federal Home Loan Bank Board.

We believe that the premium structure of the FSLIC has some order to it. There is a regular premium of one-twelfth of one percent. There is an additional assessment permitted to make up for losses in excess of one-eighth percent of deposits in any 1 year, and the additional 1 percent assessment which legislative history we believe indicates is for liquidity purposes.

An example of that would be if the fund resources were tied up in real estate assets or other illiquid assets, then the additional cash could be used where cash was needed, but there is a substantial question as to whether there is authorization to invade that fund on a basis in which it would not have to be repaid.

So if the 1 percent were taken in under any circumstances, it would have to be refunded to those who had put it up. There is no authorization to take it and use it as other reserves without repaying it.

Mr. **Wylie**. Well, in that same context, in legislative language it goes on to say, it would in effect place this $1 billion:

> Ahead of any borrowings from the Federal Government because it is assumed that such a right would be exercised by the Corporation before it made any call on the Treasury's borrowing authority. This approach is in line with a longstanding position of the savings and loan associations that insofar as possible, they should pay their own way in their insurance corporation.

I don't know, it seems to me as if that would—that is a letter from Mr. C.R. Mitchell, legislative committee chairman, to Hon. A. Willis Robinson, who was chairman of the Senate Banking Committee at the time, and he is responding to a question from Mr. Robinson which was propounded to him by the United States Savings and Loan League on June 15, 1965.

I think that maybe we ought to get that into the record if the gentleman from Georgia would agree.

Mr. **Gray**. We would be happy to send you a legal memorandum put together by our staff.

Mr. **Wylie**. I don't want to prolong that. That is fine. I was under the impression as I said that you did have the authority under current law to provide for this 1 percent assessment if the Board found it necessary.

[In response to the request of Congressman Wylie, the following legal memorandum was submitted for the record by Mr. Gray:]

Legal Memorandum Regarding
1% Deposit Authority Under
the National Housing Act

The Federal Home Loan Bank Board ("Board"), is presently authorized to call for a deposit or deposits in the Federal Savings and Loan Insurance Corporation ("Corporation" or "FSLIC") by insured institutions in a total amount not to exceed one percentum of the total amount of all deposits and accounts in all insured institutions (§ 404(i)(1) National Housing Act, 12 U.S.C. § 1727(i)(1)). Although § 404(i) has been in effect in substantially the same form since 1965, it has never been used. After its enactment in 1965 as part of the Housing and Urban Development Act of 1965, § 404(i) was amended twice, in 1973 and 1982. The 1982 amendment merely redesignated former subsection (h) of § 404 as subsection (i). The 1973 amendment effected some changes in the manner in which the Corporation could exercise its authority to repay deposits, described in Part C below.

A. Legislative History

Under § 404(i)(1), the Board is not required to proceed by rulemaking or other specific procedure to collect the deposit or deposits; § 404(i)(1) specifies that the deposit "may from time to time be required by call of the Federal Home Loan Bank Board." In addition, § 404(i)(1) provides that the "total amounts" used as standards under the regulation "shall be determined or estimated by such Board or in such manner as it may prescribe."

Although the statute imposes virtually no restrictions on the Board's authority to call for such a deposit or deposits, the legislative history of § 404(i) indicates that the primary Congressional objectives were limited. The Report of the Senate Committee on Banking and Currency states that "[t]he committee expects that the Board will give reasonable notice of payment of calls to insured institutions, and hopes that the Board will not ordinarily find it necessary to call for deposits in increments greater than one-fourth of 1 percent in 90 days." S. Rep. No. 378, 89th Cong., 1st Sess. 73 (1965) ("Senate Report", a copy of which is attached).

More significantly, the Senate Report further states that "[t]he committee intends that calls for deposits would be made only when and to the extent needed to provide liquidity for the Corporation," and sets forth a general description of the primary objectives of the legislation:

> The new provision would provide additional liquidity for the Corporation; it would give standby authority for use if the Insurance Corporation's liquidity falls below a reasonable level. In this connection, the committee noted the distinction between short run pressures on liquidity, which this proposal is designed to meet, and adequacy of the reserve fund to bear ultimate losses, as to which the committee discerned no problem. It is believed that there would ordinarily be no need to require any deposits as long as the Corporation's resources in the form of cash and Government obligations are not below 1 percent of insured liabilities.

Senate Report at 73.

B. Inherent limitations on the use of deposit authority

The express language of § 404(i)(2) NHA, 12 U.S.C. § 1727(i)(2), requires the Corporation to credit insured institutions with an annual return on their outstanding deposits with the Corporation at a rate equal to the average annual rate of return on investments in United States obligations held by the Corporation. The statute also authorizes the Corporation "in its discretion" and "at any time" to repay all deposits, or to repay a pro rata portion of each of such deposits (§ 404(i)(3) NHA, 12 U.S.C. § 1727(i)(3)).

A "deposit" under § 404(i) would be a debt of the Corporation, of course, and in this case a debt that would accrue interest at the same rate at which the Corporation earns a return on its authorized investments. Accordingly, although repayment of the deposit or deposits may be delayed or deferred, the Corporation's net assets (assets in excess of obligations) would not be increased by any deposit made under the authority of § 404(i) or by any deferral of repayment of such deposits.

C. 1983 Amendments

The 1973 amendments to subdivisions (2) and (3) of what was then § 404(h) removed references to the Corporation's providing for a return and a repayment pursuant to regulations. This made it clear that the Corporation could implement all aspects of the deposit call procedure without engaging in rulemaking.

D. Conslusion

Existing authority of the Corporation to call for deposits in an aggregate amount up to 1 percent of accounts and deposits in insured institutions enables the Corporation to improve its cash position. The deposits would be debts of the Corporation, however, and would earn at a rate equal to the Corporation's own rate of return on authorized investments. Accordingly, the net assets of the Corporation (assets in excess of obligations) would not be increased by a call for deposits under present authority.

Attachment

FILE COPY

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Calendar No. 366

89TH CONGRESS } SENATE { REPORT
1st Session } { No. 378

HOUSING AND URBAN DEVELOPMENT ACT OF 1965

REPORT

OF THE

COMMITTEE ON
BANKING AND CURRENCY
UNITED STATES SENATE

TO ACCOMPANY

S. 2213

TOGETHER WITH

INDIVIDUAL AND MINORITY VIEWS

JUNE 28 (legislative day, JUNE 25), 1965.—Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE
85-010 WASHINGTON : 1965

FEDERAL RESERVE ACT

Section 1012 amends section 24 of the Federal Reserve Act which authorizes national banks to make real estate loans—loans secured by first liens on improved real estate—under certain conditions specified in that section.

Under the present law a national bank may purchase an existing obligation secured by a real estate loan if it purchases the entire obligation but the wording governing purchase of participations requires further clarification. The first amendment would remove any doubt as to the authority of national banks to purchase participations in existing real estate loans.

This section also amends such act to authorize construction loans up to 30 months in length as an exception to the limitations on real estate loans. Under the present law such construction loans may not exceed 18 months.

SAVINGS AND LOAN ASSOCIATIONS

Section 1013 of this bill would authorize Federal savings and loan associations to make mortgage loans secured by fraternity or sorority houses, or college dormitories, outside of the 20-percent limitation.

The committee believes that this additional lending authority by Federal savings and loan associations will encourage more financial support for the construction of college housing and related facilities.

Section 1013 of the bill would also add a new provision to title IV of the National Housing Act, under which the Federal Savings and Loan Insurance Corporation was created. This would give the Federal Home Loan Bank Board standby authority to require insured savings and loan associations to make deposits up to 1 percent of their savings in the Federal Savings and Loan Insurance Corporation. These deposits would receive a return equal to the rate of return on the Corporation's investments in obligations of or guaranteed by the Government, and they might be repaid by the Corporation in whole or in part at its choice.

This provision follows section 2 of S. 2081, introduced by Senator Robertson, at the request of the Federal Home Loan Bank Board. Letters supporting this bill, and particularly endorsing section 2, were received from the U.S. Savings and Loan League and the National League of Insured Savings and Loan Associations and are printed below:

UNITED STATES SAVINGS & LOAN LEAGUE,
Washington, D.C., June 15, 1965.

HON. A. WILLIS ROBERTSON,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The United States Savings & Loan League would like to go on record in support of S. 2081, which you introduced by request.

There has been a substantial increase—especially in the past 15 years—in the insured deposits and savings in the institutions which the FDIC and the FSLIC insure. This increase suggests that Congress in this session might give serious consideration to the statutory arrangements by which these corporations would have additional access to funds in emergencies. S. 2081 would approach this objective in two ways.

In section 1, it would increase the power of the FDIC to borrow from the U.S. Treasury from $3 billion to $4 billion and the authority of the FSLIC to borrow from the Treasury of $750 million to $2 billion. Such an increase merely updates the ratio of this borrowing authority to the outstanding obligations in institutions insured by the corporations.

The second approach, which is confined to the FSLIC but which the league believes to be equally important, would give the insured savings and loan associations themselves an opportunity to provide emergency funds to their insurance corporation. Under section 2 of the bill, it is provided that the Federal Savings and Loan Insurance Corporation could require of the associations which it insures cash deposits up to 1 percent of each institution's savings accounts. This section, if used to the maximum, would add approximately $1 billion of liquidity to the Insurance Corporation. It would, in effect, place this $1 billion ahead of any borrowings from the Federal Government, because it is assumed that such a right would be exercised by the Corporation before it made any call on the Treasury's borrowing authority. This approach is in line with the longstanding position of the savings and loan associations that insofar as possible they should pay their own way in their Insurance Corporation.

If the Senate Banking and Currency Committee has reservations at this time about increasing the Treasury borrowing authority of the two insurance corporations as provided in the first section of S. 2081, the second section might still be enacted on its own. The league would support a decision of the Banking Committee to make section 2 of S. 2081 part of the pending Housing and Urban Development Act of 1965. The original FSLIC statute was enacted as part of the National Housing Act and is still included in title IV of that act. An amendment relating to the Corporation could thus appropriately, it seems, go into the Housing Act this year. If enacted, this would give the Federal Savings and Loan Insurance Corporation ample liquidity for any unusual demands inthe foreseeable future.

Sincerely,

C. R. MITCHELL,
Legislative Committee Chairman.

NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATION,
Washington, D.C., June 16, 1965.

Hon. A. WILLIS ROBERTSON,
Chairman, Committee on Banking and Currency,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The National League of Insured Savings Associations endorses the objectives of S. 2081, a bill designed to update and improve the liquidity position of the Federal Savings and Loan Insurance Corporation.

Section 1 of the bill would increase from $750 million to $2 billion the authority of the FSLIC to borrow funds from the Treasury Department. This so-called emergency line of credit to the Treasury has never been used in the 30-year history of the Corporation, and it is doubtful that the time would ever come when such a call would be necessary due to numerous safeguards written into the Nation's savings and loan system.

Among these safeguards are the reserves of FSLIC member associations which now exceed $7.6 billion and are accumulating at an annual rate of $700 million. In addition, the primary and secondary reserves of the FSLIC total more than $1.3 billion—which represents a doubling in the Corporation's loss reserves during the past 4 years.

The league believes that the FSLIC should rely primarily upon the industry in the unlikely event that the Corporation would require additional liquidity. However, if the administration and the Congress believe an increase in the line of credit to the Treasury for the FSLIC and the Federal Deposit Insurance Corporation is appropriate, the league would register no objection.

Section 2 of the bill would grant the FSLIC standby power to call upon insured associations for deposits not exceeding 1 percent of their aggregate obligations on withdrawable or repurchasable shares, investment certificates, and deposits. The league endorses this provision.

The record of the Insurance Corporation in helping to protect the savings of the people is unmatched in modern financial history. It is our believe that provision for the proposed 1-percent call for deposits would further strengthen the Corporation and inspire still greater confidence in the savings and loan system of the Nation.

The league believes firmly that the industry should continue its historic practice of underwriting the cost of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation and not rely on taxpayer funds for this purpose.

Accordingly, the league would favor enactment of section 2 of the bill.

The league believes that any prospective call on the industry should be handled in such a way as to minimize the impact upon insured associations and the liquidity position of these institutions.

For example, during the construction season, insured institutions are under pressure to provide funds for homebuilding and sales financing. Usually, in this period, the liquidity position of the industry is under pressure as commitments are fulfilled. Thus we would urge the Board to provide adequate notice to the industry prior to making a call for deposits from the industry and take any other steps which would ease the obvious strain upon the industry's liquidity at the time of the call.

It is our understanding that the authority sought by the Board would be in fact exercised only at such time as the Corporation might be required to acquire a substantial volume of mortgage assets and thereby deplete its liquidity. The League hopes that the FSLIC would follow a policy of expediting the orderly liquidation of mortgage assets which accumulate in its portfolio in order to provide additional liquidity and minimize the Corporation's reliance upon the authority provided in S. 2081.

The League wishes to express its appreciation to you and the committee for the opportunity to present these views.

Sincerely yours,

KENNETH G. HEISLER,
Executive Director.

This provision was included in order to make available additional financial resources for the Corporation, within the traditional framework through which the industry has financed the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation by premiums and assessments on insured institutions, and has built up a reserve fund which now amounts to more than $1.3 billion.

The new provision would provide additional liquidity for the Corporation; it would give standby authority for use if the Insurance Corporation's liquidity falls below a reasonable level. In this connection, the committee noted the distinction between shortrun pressures on liquidity, which this proposal is designed to meet, and adequacy of the reserve fund to bear ultimate losses, as to which the committee discerned no problem. It is believed that there would ordinarily be no need to require any deposits as long as the Corporation's resources in the form of cash and Government obligations are not below 1 percent of insured liabilities.

The committee intends that calls for deposits would be made only when and to the extent needed to provide liquidity for the Corporation. The committee expects that the Board will give reasonable notice of payment of calls to insured institutions, and hopes that the Board will not ordinarily find it necessary to call for deposits in increments greater than one-fourth of 1 percent in 90 days. Deposits would, of course, be returned to the member institutions, in whole or in part, as soon as the need for them ends. The committee also expects the Board to take into consideration this new authority to require deposits, and the extent to which it has been exercised from time to time, when determining the overall liquidity regulations of the Board

BEST COPY

Lease guarantees for certain small business concerns

Section 1008.—Adds a new title IV to the Small Business Investment Act of 1958 to authorize the Small Business Administration to guarantee payment of rentals under leases of commercial and industrial property entered into by small business concerns that are (1) eligible for loans under section 7(b)(3) of the Small Business Act or (2) eligible for loans under title IV of the Economic Opportunity Act of 1964.

The guarantee powers shall be exercised to the greatest extent practicable in cooperation with qualified surety or other companies on a participation basis.

A uniform annual fee shall be payable for the Administration's share of any guarantee. The fee shall not exceed 2½ percent per annum of the minimum annual guaranteed rental payable under the guaranteed lease. Fees may also be charged for the processing of applications for guarantees.

A revolving fund is established for carrying out the guarantee program. Initial capital of $5 million for the fund is transferred from the fund established under section 4(c) of the Small Business Act. All receipts from the guarantee program shall be deposited in the fund. The initial capital shall be returned to its source in such amounts and at such times as the Small Business Administrator determines to be appropriate.

FHA conforming amendments

Section 1009.—Makes conforming amendments in the National Housing Act made necessary by provisions in the bill which consolidate FHA insurance funds into the general insurance fund.

Repeal of special provision in Urban Mass Transportation Act

Section 1010.—Repeals section 9(c) of the Urban Mass Transportation Act of 1964 which requires that contractors, in providing facilities or equipment which have received loan or grant assistance under the act, "shall use only such manufactured articles as have been manufactured in the United States."

Redevelopment areas—Technical provision

Section 1011.—Amends sections 103 of the Housing Act of 1949 and 701 of the Housing Act of 1954 to add references to acts supplementary to the Area Redevelopment Act.

Federal Reserve Act

Section 1012.—Amends section 24 of the Federal Reserve Act to permit national banks to (1) purchase participations in loans secured by real estate and (2) make loans for the construction of industrial or commercial buildings to have maturities up to 30 months (now 18 months).

Savings and loan associations

Section 1013(a).—Amends section 5(c) of the Home Owners Loan Act of 1933 to authorize Federal savings and loan associations to make loans outside of their 20-percent limitation secured by college dormitories or fraternity or sorority houses, or housing for staffs of colleges or hospitals.

(*b*) Amends section 404 of the National Housing Act to require an association to make deposits in FSLIC up to [illegible] percent of the association's savings as required by call of the Federal Home Loan Bank Board.

CORDON RULE

In the opinion of the committee, it is necessary to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate in order to expedite the business of the Senate in connection with this report.

Mr. **Wylie**. You mentioned the various ways that you can capitalize or recapitalize the fund, and you mentioned this 1 percent. You mentioned a couple other procedures.

You didn't mention the merger of the FDIC and FSLIC fund. That is one proposal which Mr. Isaac suggested. That is not on your list of possible categories.

Mr. **Gray**. I think I did mention that a merger of the two funds was an alternative that I opposed if you didn't have sufficient resources to deal with the problems.

But I think that really doesn't solve the problems that we are talking about in terms of——

Mr. **Wylie**. I want to ask one more question and you can respond more. You can expand on that for the record if you wish.

Ohio seems to be in the forefront of a lot of these problems, and we have had a situation in Columbus where an insurance company wanted to infuse assets into a thrift. Is that another possibility, a possible opportunity for extra money, allowing failing or troubled thrifts to be acquired? They can be acquired by other thrifts now and they can be acquired by banks, but what about insurance companies?

Mr. **Gray**. Yes, insurance companies can. We, as a matter of policy, have had a problem with thrift affiliations with underwriters and market makers in corporate securities. In those situations, we have developed a means by which we could erect a Chinese wall around that kind of operation and I do know that we have dealt with that particular situation in the way that we felt appropriate as a board.

But in terms of insurance companies acquiring thrifts, we are all for that if they are willing to help the FSLIC solve its problems.

Mr. **Wylie**. That is not high on your priority list as a way to solve the problem?

Mr. **Gray**. I think that would be the case, but again what I would try to develop, as I said earlier, was the need to provide very large amounts of assistance when bidders come in and want to take failing institutions, and the assistance required is very great in most cases.

The assistance has to be provided by the FSLIC.

Chairman **St Germain**. Whether it is an insurance company or anybody else, they still want assistance from the FSLIC and that is another big cost to the FSLIC.

Mr. **Gray**. Right.

Chairman **St Germain**. Chairman Gray, let me ask you this. With the FDIC and the Federal Reserve and their examiners, does OMB treat them the same as they treat your examining staff?

Mr. **Gray**. They don't——

Chairman **St Germain**. Are you on parity, equal treatment, et cetera?

Mr. **Gray**. The Federal Reserve and FDIC do not come under oversight of the OMB.

Chairman **St Germain**. Oh, really?

Mr. **Gray**. No.

Chairman **St Germain**. Well then, what has the Federal Home Loan Bank Board done wrong that you have the OMB watching over you like a big brother?

Mr. Gray. Well, the Bank Board has been under OMB for many years.

Chairman St Germain. Maybe that should be changed so that you could function a little more effectively.

Mr. Barnard.

Mr. Barnard. Thank you, Mr. Chairman.

Mr. Chairman, I would just like to inquire at this particular time. I have some questions about the proposal that has been made to Mr. Gray under section 406 of the National Housing Act to set up one of these 406 corporations. I will certainly withhold these questions if for some reason you might be having a special hearing on the 406, or we might explore it somewhat.

Chairman St Germain. I would say to the gentleman, I think that it would be illuminating for the Members who are here and those who are going to read the transcript of these hearings very attentatively if you were to ask preliminary questions about the 406 and that would, I think, be advisable.

Mr. Barnard. I think it is in keeping with the purpose of our hearing this morning.

Chairman St Germain. Indeed I do.

Mr. Barnard. In which we are trying to find answers to the problems.

This has been suggested as an answer. As I understand it, Mr. Chairman, on October 2, the Federal Home Loan Bank Board received an application for the formation of a 406 corporation. The name comes from the latitude allowed by section 406 of the National Housing Act of the Home Loan Bank Board to charter Federal savings and loans to assist the Home Loan Bank Board in handling the currently troubled savings and loan situation.

This application is unusual in that it is really in the nature of a petition for you to form such an association.

Mr. Gray. Yes.

Mr. Barnard. It is not a straight application by persons wanting to set up one to run as their own business.

When you inquired as to this 406 corporation, I understand that you said the Board welcomed the application. Does this mean that you feel that this is an answer to some of the problems of the FSLIC and Home Loan Bank at this time, and if so, how much?

Mr. Gray. Well, we welcome all applications, of course, from our member institutions and we also welcome this application as a possible basis for an innovative approach to meeting some of the problems that the FSLIC faces.

This is only one element in a large mosaic of things. It seems to me that it is worth looking at very carefully, but it certainly is not a panacea in its own right.

This corporation, this Federal savings and loan association, if it were formed, would have the sole purpose of disposing of assets held by the FSLIC. The idea behind it, as I understand it, is to maximize the return on the disposition of those assets.

Mr. Barnard. Are you in a position to say this morning that the FSLIC would make the contribution of a $500,000 ownership in such corporation?

Mr. Gray. It is more like $500 million.

Mr. Barnard. Excuse me, I mean $500 million, yes.

Mr. GRAY. Essentially, I believe that that is the nature of the proposal, yes.

Mr. BARNARD. And you feel that the corporation would make that investment?

Mr. GRAY. Well——

Mr. BARNARD. It is not actually an investment of cash, it would be a transfer of assets as I understand, to that corporation.

Mr. GRAY. I want to be as responsive as I can to your question. It must be noted that the Bank Board is currently looking at this proposal which we have had for I guess several weeks now. We are trying to determine all of the aspects of this related to legal subjects, policy, and what such a Federal association could do to improve the maximization of return on assets for the FSLIC.

We have not reached any conclusions as of yet.

Mr. BARNARD. And you really don't know at this point whether the 12-home loan, district home loan bank boards which would be looked at to invest another billion dollars in this, whether or not they would make their contribution, is that true?

Mr. GRAY. Make equity investments in this association?

Mr. BARNARD. Yes.

Mr. GRAY. We are looking at that. But I cannot tell you at the moment.

Mr. BARNARD. Would those decisions be made individually by each regional Home Loan Bank Board?

Mr. GRAY. Yes, they would.

Mr. BARNARD. In other words, some could do it and some could not?

Mr. GRAY. Yes, that is the case.

Mr. BARNARD. From what you said, then, you really are not in a position this morning to answer the problem, the question rather, and it is a legal problem, a legal question, as to whether or not the FSLIC could own common equity in such an association?

Mr. GRAY. We believe that the FSLIC could, but we have not made as of yet a legal determination relative to investment by the Federal Home Loan Banks.

Mr. BARNARD. All right. In other words, you think the FSLIC could but you do not know whether the home loan bank boards could make such an investment?

Mr. GRAY. Well, I think we have to look at these legal issues very, very carefully before making a final decision. Any decision in that regard, incidentally, would be shared on a consultative basis with you, as chairman of the Subcommittee on Government Operations, and with the chairman of this subcommittee.

Mr. BARNARD. Mr. Chairman, is there any way for you to respond this morning as to how much this 406 idea would help you in the problem immediately at hand as far as increasing your capitalization of the FSLIC fund?

Mr. GRAY. Well, I don't think that this association is meant to be a recapitalizer, but rather it is a loss avoidance mechanism to get a better return on the assets that we have.

To quantify that at this point in the absence of some information that we have requested from the FSLIC staff, I think would be premature.

Mr. BARNARD. Would you feel that approval of the 406 corporation like this could justify you postponing the 1-percent set-aside?

Mr. GRAY. As I said before, I do not consider this to be a means or a mechanism by which the fund could be recapitalized per se. I see it as a means by which the insurance corporation could receive a better return on its assets than we are currently getting, but I don't think the idea behind this is to recapitalize the fund. I don't see how that would really happen in meaningful terms.

On the other hand, it is very important that we get every penny that we possibly can on the assets that we hold at the FSLIC. Every penny that we save helps the FSLIC.

Mr. BARNARD. In that statement, though, are you suggesting then that the FSLIC is not properly staffed or equipped to proceed to recover the full value of these assets that they have taken in?

Mr. GRAY. I am glad you asked the question. Let's take a look at the FSLIC for 1 minute.

We now have 134 people on staff, of which 121 are professionals. These professionals are paid between $19,000 and $48,000 a year. They receive an average annual salary of $35,000 a year. We have a turn-over rate at the FSLIC which is 33 percent, which is three times the rate in Government service as a whole.

Let me add parenthetically that we have 25 in our Liquidation Division, 6 of which are clerical. When you have that kind of situation and compare that to the 2,500 in the Liquidation at the FDIC, for example, you are faced with a real problem, particularly given the $3 billion of assets that must be managed.

Mr. BARNARD. Under 406, you would get out from under that problem, because the employees of the 406 corporation would not come under the OMB; is that right?

Mr. GRAY. That is true. They would be employees of the federally chartered savings institution. For the first time, if this application in some form were to be approved, the association could hire the kind of talent—and these skills in asset disposition require a great deal of skill and I think more than we can possibly expect from employees that are making $35,000 a year given what people in this business earn on a daily basis—and the skills required to effectively dispose of assets. So this would provide an advantage to this association, in maximizing return on those assets.

Mr. BARNARD. Thank you.

Chairman ST GERMAIN. I would just comment that I am hoping you look very closely at the auditing and accountability because wouldn't we be talking of an enormous amount of money, billions of dollars, here?

Mr. GRAY. Yes.

Chairman ST GERMAIN. So we want to look at this very carefully. We had better discuss this more.

Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

I appreciate your testimony, Chairman Gray. I am very sympathetic with your personnel needs and recently in my area, I came across an example of an FSLIC liquidation in which the receiver had a minimal, almost nonexistent public notice of sale.

I assume that was due to the demands on the overworked, overburdened employees?

Mr. Gray. Yes, sir.

Mr. Cooper. My first question has to do with the 1-percent suggested levy. Would you be a little more specific about that? How much money would you estimate that a 1-percent fee would raise?

Mr. Gray. As a deposit set-aside, it would be based on the deposits the institutions in our industry held, which currently is about $8.5 billion.

Mr. Cooper. So that is the amount of money that you think is clearly needed? I assume that is the way you want about setting the fee, you needed——

Mr. Gray. Let me emphasize we did not make that proposal, but we cited it as an alternative among not very many alternatives that could be used.

Mr. Cooper. But if you—if that is the pricetag associate with one of the alternatives, that would mean in general you have a real need for about $8.5 billion, so if we had to quantify the problem, it would be an $8.5 billion problem?

Mr. Gray. I think it is premature in my own mind to say exactly what we would need in the foreseeable future.

But if that alternative were exercised, the insurance fund would have additional resources to work with.

Mr. Cooper. Thank you.

On a different topic, the authority you would have to authorize interstate mergers of failing institutions, there has been some interest about whether that power is or should be broadened, for example, to include failing institutions.

As I understand it, there are a wide number of thrifts that really exist only on some sort of theoretical basis, and they could be declared failing at pretty much anytime.

That in turn would give you broad powers to authorize interstate mergers. Are you working now on such proposals to broaden the use of your powers in that way?

Mr. Gray. Well, we welcome and have welcomed acquirers of failing institutions.

When acquirers come in we want them to help us at the FSLIC. One of the difficulties that we have is that in these cases where bad assets are involved, assistance costs tend to be very, very high, and as I have stated a little earlier this morning, or suggested at any rate, we are limited in terms of our resources, in terms of the unobligated balance, to deal with the high assistance costs, because each one of those assistance case costs counts against the unobligated reserve.

Mr. Cooper. In an effort to reduce those assistance costs charged to you, are you considering loosening your policy to allow more of these interstate Federal savings and loan mergers?

Mr. Gray. We allow all of them that we can.

Mr. Cooper. Are you——

Mr. Gray. All of them that produce assistance to the FSLIC, if you will, and I don't think we have any limits on that. We do follow the guidelines established in Garn-St Germain, this four-tier approach, but any entity that is willing to play by our rules and help us at the FSLIC is welcomed.

We do have concerns and have expressed them, as did the Senate of the United States last year—with respect to the affiliations or acquisitions by investment bankers that make markets and underwrite corporate securities—but other than that, there are no restraints.

Mr. Cooper. In an area, for example, that has adopted a regional compact, would you feel less of a constraint in going ahead and approving a merger between failing or weakened institutions, institutions that might on the surface look fairly sound to an outsider.

Would you feel it easier to go ahead and approve an arrangement like that?

Mr. Gray. Well, the law allows as a result of the Supreme Court decision branching into other States in a compact, although the purchase by one institution of another across State lines still requires Bank Board approval, and since we also operate the Federal Savings and Loan Insurance Corporation, we need to deal with either problem and try to save money for the FSLIC at the time that occurs.

Mr. Cooper. Thank you very much. My time has expired.

Chairman St Germain. I have to ask you a question. You said that the Supreme Court decision allows branching interstate?

Mr. Gray. Where there are reciprocity agreements, it is all right. It upheld the validity of interstate compacts.

Mr. Wylie. Mr. Chairman, I thought that was already statutory law as far as thrifts are concerned. The Supreme Court case—maybe this is the one you are referring to—applied to banks, didn't it?

Chairman St Germain. That is correct.

Mr. Gray. Yes.

Chairman St Germain. I don't think the Supreme Court decision was responsible for permitting S&L's to branch interstate.

Mr. Gray. No; but I am saying the McFadden Act does not apply in the case of branching where you would have an interstate compact with thrift.

Chairman St Germain. I would suggest you might want to clarify that for the record after consultation with your legal adviser, Mr. Raiden. Mr. Leach?

Mr. Leach. Thank you very much.

One has the sense that the S&L crisis, like the Farm Credit System crisis, is crying wolf at the door. It has been with us a long time, but it is nonetheless real. You should be assured, above anything else, that Congress will be very supportive of the toughest kind of regulatory actions, and that failure on the Bank Board's part to take the toughest alternatives should not be attributed to Congress. The buck shouldn't be passed to Congressmen.

Mr. Gray. I think that is absolutely true. I agree with you.

Mr. Leach. At this time, Congress is pretty committed. I would also say the issue has been raised by Gramm-Rudman. Without constraints that lead toward balanced budgets or constraints on deficits, it is a lot easier for Congress to assert the full faith and credit of the U.S. Government, and a lot harder to back up those assertions. So the necessity for the Bank Board to act is very real and the preferability for Congress to act is even greater. In this regard, I don't know a Bank Board Chairman who has been quicker in raising the flag, and we appreciate that.

I don't fully understand your warehousing theories. If it is based simply on the need to hire new people, it makes some sense to me although there might be a better way of achieving that goal. But one of the problems with almost all approaches to holding assets is that managers have a difficult time shedding them.

I think super banks have an almost inordinate problem of sticking to very precise purposes, and that a super bank might have some difficulties if that is what you have in mind.

Mr. **Gray**. No, no; it is not a super bank. It would be, and it was proposed to the Bank Board. We did not propose the formation of this Federal association, but we are talking about here, presumably, a responsiveness to the Federal Home Loan Bank Board in Washington throughout appointment of directors to this corporation.

Mr. **Leach**. Well, let me just say that one of the difficulties is how you assess value for what you buy, and then how you assess judgment on how long you hold assets, and those become real difficulties. Let's discuss your 1-percent solution. I think——

Mr. **Gray**. Alternative.

Mr. **Leach**. Alternative, although some may call it a solution—some support for that substantial figure being infused into the FSLIC, but one of the problems is one of equity. Obviously, it represents a transfer from stronger institutions to weaker, and I would be very interested to know whether you have considered risk base premium assessments where a stronger institution would put in a smaller percentage; a weaker institution, a higher percentage.

Mr. **Gray**. Yes, we did. That is precisely how one could describe our risk premium proposal. The higher the net worth of an institution, the less supplementary premium it would pay.

Mr. **Leach**. I personally think that is a very positive resolution of the issue, and I hadn't followed that exactly. Let me ask you, have you done any assessments on the prospect of institutions operating out of the savings and loan system and shifting their charters to bank charters if your proposal goes through.

Mr. **Gray**. I think that is possible. If that were the scenario, I think that is possible. How many would consider that strongly enough to actually do it is another question that needs to be answered. There is a great benefit to being a member of the Federal Home Loan Bank System in that advances are provided to member institutions with maturities of up to 20 years, which is not available in the Federal Reserve banks.

We are talking about very, very short-term money at the Federal Reserve banks and for mortgage lenders—the restructuring benefits that come from long-term advances are very, very important.

Mr. **Leach**. Good. Thank you. I have no further questions.

Chairman **St Germain**. I don't think we ought to neglect mentioning the advantage to a S&L holding company, as opposed to a bank holding company.

Mr. **Gray**. The unitary savings and loan holding company—yes.

Chairman **St Germain**. Yes. That is a rather valuable asset, isn't it?

Mr. **Gray**. Yes, it is.

Chairman **St Germain**. It certainly is.

Mr. Wortley.

Mr. Wortley. Thank you very much. Good morning, Mr. Gray.

Mr. Gray. Good morning.

Mr. Wortley. We have had a number of previous witnesses that have come up here and urged the adoption of a market value accounting. I realize that you probably can't move in that direction at this point in time. Double that, this would be a good, long-term goal to shoot for.

Mr. Gray. Well, I don't know how many years we are talking about, but it would, if it were a goal, I would place that kind of a goal out over some considerable period of time.

Mr. Wortley. Considerable meaning how long?

Mr. Gray. Years. Let's say——

Mr. Wortley. Five years, ten years?

Mr. Gray. Ten years.

Mr. Wortley. Light years ahead.

Mr. Gray. Light years.

Mr. Wortley. As I understand it——

Mr. Gray. That is a fundamentally different approach from GAAP accounting—historical cost accounting.

Mr. Wortley. As I understand it, you have asked for the authority to restructure the priorities of claims against bankrupt estates and specifically you would place the FSLIC ahead of depositors and general creditors. Am I correct in that?

Mr. Gray. Yes, yes, we have.

Mr. Wortley. What effect would this have upon secured creditors?

Mr. Gray. Let me call upon the general counsel of the Federal Home Loan Bank Board, and I will be happy to comment also.

Mr. Raiden. Mr. Wortley, we would not contemplate it would have any effect on secured creditors. Secured creditors would continue to be prior to unsecured creditors. Insured deposits would then be prior to uninsured deposits.

Mr. Wortley. So the secured creditors are still first in line.

Mr. Raiden. Yes.

Mr. Wortley. This proposal of yours—are you thinking about asking for this to be implemented in the very near future or is this a long-range plan also?

Mr. Gray. Well, we would like the Congress to consider that sooner than later.

Mr. Raiden. We think it is a matter of your generosity. There are some States, for example, in which the claims of general creditors come ahead of account holders which leaves us with the effect of the FSLIC in effect insuring debts, lawsuits, other matters in some of those States.

Mr. Wortley. Very interesting.

In your prepared statement, Mr. Gray, you alluded to the unobligated reserves of the FSLIC about $3.2 billion. What are the obligations which are imposed upon the remainder of these reserves which are somewhere around $2½ billion?

Mr. Gray. The remainder?

Mr. Wortley. Yes.

Mr. Gray. The reserves of the fund are actually around $6.7 billion.

Mr. Wortley. $6.7 billion.

Mr. **Gray**. Yes. But the rest is obligated.

Mr. **Wortley**. What obligations are imposed upon those? Are we talking about the troubled institutions now?

Mr. **Gray**. Right. right.

Mr. **Wortley**. And again, the figure is approximately how much?

Mr. **Gray**. For the unobligated reserves?

Mr. **Wortley**. Yes.

Mr. **Gray**. $3.2 billion at the end of the third quarter, end of the fiscal year.

Mr. **Wortley**. And the $6 billion plus that you are referring to, are these the roughly 25 percent to a third of the troubled institutions?

Mr. **Gray**. Those are obligations that we already have above and beyond the unobligated reserves.

Mr. **Wortley**. They are what?

Mr. **Gray**. For past resolution of cases.

Mr. **Wortley**. For past resolutions of cases. This doesn't have anything to do with the future.

Mr. **Gray**. That's right.

Mr. **Wortley**. No wonder you have some serious concerns about the direction that fund is headed at this point in time. I believe my time has expired, Mr. Chairman. Thank you.

Chairman **St Germain**. Thank you. Chairman Gray, I would like to really compliment you on one statement in particular. On page 6 of your written testimony, you comment, "Insured institutions are not and cannot be free market players like other entrepreneurial interprises."

What you mean by that is the private corporations or the publicly held corporations; right?

Mr. **Gray**. Right.

Chairman **St Germain**. Then you go on to say, "Insured depositor institutions"—I think you mean by that commercial banks as well as savings and loans associations and mutual savings banks

Mr. **Gray**. Right.

Chairman **St Germain** [continuing]. "Operate on the Federal Government's safety net in every sense." In other words, they have something that no one else has: deposit insurance up to $100,000 per account. As we can see from your appearance here today, sometimes that is difficult, particularly in these troubled times of the S&L industry. So I want to commend you on reminding everybody of this, because so frequently some of your colleagues in the other agencies come in, and they seem to forget about this.

Then, of course, we have the wish lists, the letters to Santa Claus that come in from the institutions, saying I want a brandnew red wagon and all those things.

Ms. Kaptur.

Ms. **Kaptur**. Thank you, Mr. Chairman, and Chairman Gray, for your excellent testimony.

Did I understand you correctly in response to Mr. Cooper's question? You stated that the recapitalization would be approximately $8½ billion? Did I hear that correctly?

Mr. **Gray**. That was the amount of deposits that would be involved in a 1-percent deposit set-aside.

Ms. **Kaptur**. I see. That was the 1-percent deposit set-aside. All right. I missed what that number was. Thank you.

In your testimony, you state that "the recapitalization effort would not cover losses already incurred," and one of my questions would have to do with——

Mr. **Gray**. No, no. It would. I may have said in the testimony—I am not sure—that the risk premium program would not do that.

Ms. **Kaptur**. But the recapitalization would. All right.

Mr. **Gray**. Yes.

Ms. **Kaptur**. I guess that I mixed that up. On page 12, you talk about an appropriate role for the States. You know, being from the State of Ohio, I saw the State dip into its pockets to the tune of about $100 million, and in looking at the geographic concentration of these troubled institutions, do you have any ideas on what the appropriate role of the States might be in all of this, if there is one in the recapitalization effort I am talking about?

Mr. **Gray**. You mean for a State to involve itself in recapitalization?

Ms. **Kaptur**. That's right.

Mr. **Gray**. For the FSLIC? The State legislature, the State treasury.

Ms. **Kaptur**. State chartered, FSLIC-insured institutions. Obviously you have talked about it.

Mr. **Gray**. I would say that—one of my concerns has been when liberal authorities are freely passed out by State legislatures, the States at the very same time know it will never pay a penny of loss which could occur from misuse of those more liberal authorities and that really was the thrust of what I was trying to get at, I believe.

Ms. **Kaptur**. Why should the S&L's in my district pay an additional premium to help bale out other institutions when my own State took money out of its own pockets in order to help its State-chartered institutions that had gone awry. I guess I am curious about what the mechanism would be to get some of these States to cough up some of the money.

Mr. **Gray**. In the case of the Ohio State-chartered institutions, they were not FSLIC insured.

Ms. **Kaptur**. Right.

Mr. **Gray**. That is why the State believed itself to be on the hook for resolving that big problem that they had.

Ms. **Kaptur**. Sometimes aren't we letting the States off the hook—those that have State-chartered FSLIC-insured thrifts?

Mr. **Gray**. The State-chartered FSLIC insured institutions—and there is something like 240, 250 of these in the State of Ohio—all are a part of the FSLIC System, and they contribute their regular premiums to—and special assessments to—the FSLIC, whereas the others, the other 70 or so were not contributing at all to the FSLIC, were totally separate from the FSLIC. I am not sure I understood.

Mr. **Wylie**. Will the gentlelady yield?

Ms. **Kaptur**. Yes.

Mr. **Wylie**. We have a very interesting question here. I think what the lady is saying, if the State-chartered institution is given additional authority which increases the risk over and beyond what a federally chartered S&L would be allowed to do, or the risk they would take, shouldn't the State pick up some of the slack there?

I don't know what the mechanism would be, but I wish you would get the States to do it. But should that be accompanied, if they are going to allow them to invest in wildcat oil, why shouldn't there be a premium on it?

Mr. GRAY. That is precisely what the Bank Board has proposed, although the FSLIC would collect the special premium for any activities that go beyond what the Congress itself found suitable for Federal deposit insurance for federally chartered institutions.

So that in the State of Ohio, if you had a State-chartered thrift going beyond what the Congress provided, even though the State allowed it, that institution would be required to pay a supplementary risk premium to cover the risk of loss of activities which go beyond the confines of the Garn-St Germain authorities.

Ms. KAPTUR. But that is future-oriented, correct? That would be from the date of enactment forward.

Mr. GRAY. Yes.

Ms. KAPTUR. It wouldn't create any kind of penalty to do something about the losses that were incurred looking back.

Mr. GRAY. Relative to our proposal, no, it would not. It would not.

I think it would be very difficult to impose it on a retrospective basis.

Ms. KAPTUR. Thank you.

Mr. GRAY. Thank you.

Ms. KAPTUR. I think I have a second left here. What were the administrative procedures and reasons you used to almost double your number of examiners, promote them, and pay them more?

Mr. GRAY. We have not doubled it yet, but we intend to double it by the end of 1986, and the way that was accomplished was through provisions in the Federal Home Loan Bank Act and the Garn-St Germain Act, which allowed us, notwithstanding any other provision of law, to delegate this responsibility to the Federal home loan banks, and I am talking here under the supervision of the principal supervisory agents.

In doing that, these examiners left—these field examiners left civil service status and became employees of the Federal home loan banks and they report to the principal supervisory agent who, in turn, reports to the Federal Home Loan Bank Board.

So that instead of having them in civil service, reporting directly up through the Federal Home Loan Bank Board, they now report through a non-civil-service part of our system represented by the principal supervisory agent and on back to the Federal Home Loan Bank Board. So the salary setting and budget constraints——

Ms. KAPTUR. You actually have more people. It is more than just a paper change.

Mr. GRAY. Oh, yes.

Ms. KAPTUR. Why did you feel the necessity to hire more people, I guess, is the nub of my question.

Mr. GRAY. Why? Because we have to oversee a trillion-dollar industry.

We have had turnover rates of between 23 and 28 percent prior to this transfer in our examination forces in various districts, plus salaries that were paid. The average salary was $25,000 a year. The entry level salary was $14,000 a year. You can understand the nature of the turnover as a result.

Ms. **Kaptur**. I guess I find it so interesting because we are always criticized for creating more bureaucracies and paying government employees too much, and we have to cut out the fat, and then when we see the change, what happens if people get higher salaries and the numbers double. So maybe——

Mr. **Gray**. The reason they are doubling is because we simply must have more examiners. We must have better-trained examiners. We must have better-paid examiners in order to counter the difficulties that we experienced before that resulted from these high turnover rates.

For example, a survey that we did late last year indicated that only 50 percent of our examiners had been on the job for 2 years or more. So when we move them out to the Federal home loan banks, we can pay them more. We have a far better opportunity to retain more of these people. They get better benefits, frankly.

That is why the civil service employees chose to move out to the Federal home loan banks and it is a win/win situation for all of us when we are called upon to regulate a $1 trillion industry.

We have to have the kind of examination personnel off of which our supervisory agents bring about compliance.

Chairman **St Germain**. Chairman Gray, if you will allow me to answer your question, I think I can help you to further elucidate here in very few words.

If you look at the chart on your left, it depicts the number and deposits and problem S&L's; you will see that the number and amount of deposits appear to be declining.

Now, my staff tells me that the 1985 numbers reflect only the problems turned up in Federal Home Loan Bank Board examinations as of June 30, 1985, and that they may not be indicative of the actual number of problem S&L's or their deposits.

Now, earlier, you reported to this subcommittee that the number of problem institutions in 1982 was 720. In 1983, it was 676, and in 1984, it was 738.

Chairman **St Germain**. Would 900 be accurate?

Mr. **Gray**. I would not want to venture a guess. It could be but I don't know at this time.

Chairman **St Germain**. Well, your staff provided to my staff the number 900.

Mr. **Gray**. As of October 31, 1985, the number of problem institutions was 606.

Chairman **St Germain**. If you find that your staff made a mistake, let my staff know and they will let me know. But I think right now it is 900, and certainly that is good reason——

Mr. **Gray**. I think I know what you are talking about now. You are talking about the equivalent CAMEL-rated institutions.

Chairman **St Germain**. Yes, sir.

Mr. **Gray**. OK.

Chairman **St Germain**. Can you in 30 words or less explain CAMEL rating?

Mr. **Gray**. Well, CAMEL rating is actually used by the commercial banking regulators but we tried to make it understandable by relating our system to the CAMEL rating, roughly.

Chairman **St Germain**. This has nothing to do with crossing a desert?

Mr. **Gray**. No.

Chairman **St Germain**. What does CAMEL stand for?

Mr. **Gray**. I don't know.

Chairman **St Germain**. In other words, it is a rating system that goes from what to what?

Mr. **Gray**. It is a rating that goes from one to five.

Chairman **St Germain**. One to five. If it is—a rating of one is what?

Mr. **Gray**. The best.

Chairman **St Germain**. The best. As you go up toward 5, it is not like 1 to 10 with what's her name, the movie star; right? This is one to five, and it is the other way around. One is very good; five is very bad.

Mr. **Gray**. Right.

Chairman **St Germain**. That is what the CAMEL rating is.

Mr. **Gray**. That is true, although the nature of the problems, particularly when bad assets are involved, could vary significantly among those CAMEL-rated institutions.

Chairman **St Germain**. I said 30 words now.

Now, in your testimony, you said the temporary restraining orders when an institution's books and records are incomplete or inaccurate are necessary for the examiners. Section 304 of your so-called draft bill includes such authority for the agency.

Has this been a growing problem? Also, can you estimate how many institutions in the past 5 years could have been subject to such an order; that is, how many had books that were so bad that the Board could have used, or would like to have had used, a temporary restraining order?

Mr. **Gray**. Quite a few, Mr. Chairman, but I can get that number for you. I don't have it now. Quite a few.

[In response to the request of Chairman St Germain, the following information was submitted for the record by Mr. Gray:]

QUESTION:

Now, in your testimony, you said the temporary restraining orders when an institution's books and records are incomplete or inaccurate are necessary for the examiners. Section 304 of your so-called draft bill includes such authority for the agency. Has this been a growing problem and can you estimate how many institutions in the past five years could have been subject to such an order; that is, how many had books that were so bad that the Board could have used or would like to have had a temporary restraining order?

ANSWER:

The lack of adequate books and records has indeed been a growing problem and one that is seen most often at fast-growing, high-risk lenders. The Bank Board's proposed legislation would enable the Board 1/ to issue temporary orders to halt new lending or other activities at an institution until its books and records are in satisfactory condition such that the institution's true financial condition is known.

1/ It should be noted that we are not asking for this authority to be given to the Board's examiners or any other staff personnel. Under the present practice at the agency, all decisions to issue temporary orders are made by the Bank Board itself after considering staff recommendations.

In the last five years, the Bank Board has issued approximately 75 final orders to cease and desist, approximately one half of which have included provisions to correct problems with recordkeeping at insured institutions. A review of these cases has revealed that about one half of those orders (or approximately 20 cases) would have been candidates for the kind of temporary order sought by the Bank Board in its legislation. That is, they invoved institutions the actual financial condition of which was unknown due to inadequate recordkeeping when other regulatory violations and unsound practices were evident.

During the same five year period, it is estimated that at least 25 cases in which the Bank Board placed failed institutions in receivership, may have been candidates for such a temporary order to halt new lending in large or speculative ventures. Too often, we have discovered large loan transactions or investments that occurred immediately prior to the appointment of a receiver while the staff was attempting to obtain reliable evidence of an institution's actual financial condition (usually its insolvency) to enable the receiver to be appointed.

In addition, during the last 5 years, approximately 300 supervisory agreements have been executed by the Bank Board's agents. It is unknown how many of these cases may also have been considered for a temporary order had the authority been available. The problem often has been that until an examination is completed to reveal the actual financial condition of an institution, the supervisory staff has no basis to take supervisory or enforcement action. And yet the ability to complete the examination in a timely manner is dependent upon the state of the institution's own records. We are unable to quantify how many times this kind of delay has occurred before the Board's staff undertook informal supervisory action.

Mr. GRAY. By the way, we deal with these problem cases. In our Board meetings, we see this time and again. In fact, one we were involved with on Friday, the books and records were in total disarray. It is very difficult to determine the financial condition of an institution under those circumstances.

Chairman ST GERMAIN. How often do you examine institutions that have, let's say, a three or above CAMEL rating? What is the frequency of examination?

Mr. GRAY. When the problem occurs or we become aware of the problem, we try to send in examiners to deal with these institutions.

One of our problems, incidentally, has been, we have not had enough well-trained examiners to do the job as well as they or we would like.

Chairman ST GERMAIN. My question was, how frequently—let's forget any ratings at all.

Mr. GRAY. Right.

Chairman ST GERMAIN. I have an S&L. How often can I look forward to the pleasure of visitation by examiners from the FSLIC?

Mr. GRAY. If you have an institution——

Chairman ST GERMAIN. Federally chartered.

Mr. GRAY. If you have an institution that has greater problems, the likelihood of you seeing the examiners is substantially more frequent than if you are a healthy institution.

Chairman ST GERMAIN. I am a healthy institution. How often can I look forward to seeing the examiners, once a year; 18 months?

Mr. GRAY. There are various kinds of examinations, also, that we do. For example, we can send in an examiner or receive examiners just to look at something very specific at that institution that we are concerned about.

Chairman ST GERMAIN. Chairman Gray, please. There is nothing wrong—don't you examine institutions on a regular, timely basis?

Mr. GRAY. As a rule of thumb, we do.

Chairman ST GERMAIN. That is what I am trying to obtain from you. What is the frequency?

Mr. GRAY. The frequency could be as often as every 90 days, but I would say——

Chairman ST GERMAIN. For a healthy institution?

Mr. GRAY. Not for a healthy institution.

Chairman ST GERMAIN. Listen to me closely now. I want you to give me your undivided attention.

Mr. GRAY. You have it. I have a lot of noise back here.

Chairman ST GERMAIN. Could we reduce the noise factor behind Chairman Gray, please?

Now, a healthy S&L.

Mr. GRAY. Every 2 to 3 years.

[The following supplemental information was submitted for the record by Mr. Gray:]

There are currently no rigid standards for the frequency of examinations conducted by our staff. The frequency can range from that of continuous examinations where we have at least one examiner in particular institutions at all times, to as long as 3 years between the examinations.

The frequency of examinations is determined on a case by case basis, based upon extensive monitoring done by our examinations and supervisory staffs in the field as well as similar work done by Washington based personnel. We feel this system allows us to devote our limited resources to the institutions currently experiencing the most difficult problems.

Chairman St Germain. That is what I was looking for.

So that is how, absent any other knowledge, books can—I was trying to see how books can get into such disarray, and that is because, after a particular examination, they can get a little sloppy, and then comes 2 years later, you go in and you have a tragedy on your hands. That is what I was trying to get at.

Mr. Gray. You are right. I appreciate your having brought it up because if we have more examiners, we can do this more often.

Chairman St Germain. Chairman Gray, a number of financial experts, and I guess we can include Chairman Volcker, as a financial expert, view risk-related capital requirements as a workable substitute for risk-related premiums.

One of the advantages they point out is the fact that the agencies already have sufficient statutory authority to implement risk-related capital requirements to moderate risk taking.

Now, do you agree—does the Federal Home Loan Bank Board presently, have that authority as well?

Mr. Gray. Yes, we do.

Chairman St Germain. If that be the case, you are still looking to risk-related premiums; isn't that correct?

Mr. Gray. Risk-related premiums would provide additional resources to the FSLIC. Through supplemental premiums, we would not get——

Chairman St Germain. That is why you refer them to risk-related capital requirements?

Mr. Gray. Because we have a capital requirement.

Chairman St Germain. Mr. Wylie referred to credit union support for recapitalization and the fact the S&L industry opposed recapitalization.

Now, weren't the motivations a little different—the credit union motive with the trustee, because they went along with the 1 percent to preserve their tax exemption. Isn't that correct?

Mr. Gray. That may well have been one of the reasons.

Chairman St Germain. In other words, the S&L's are generally not in the same position, as we have heard earlier and as we discussed earlier, the good associations, particularly the stockholders are opposed to this for that particular reason. They didn't want to bail out the weaker institutions.

Mr. Schumer.

Mr. Schumer. Thank you, Mr. Chairman.

Welcome, Mr. Chairman of the Home Loan Bank Board. I would first like to compliment you, Mr. Gray. I think you have been the Paul Revere of our regulators in terms of letting people know of the problems that the FSLIC and the thrift industry have.

Chairman St Germain. Has either fellow been riding a horse past my window every night?

Mr. Schumer. I was going to ask him, where are all the other patriots in the administration, because you seem to be the only one. And this relates to my first question which is: Are you getting any support from anyone in the administration?

We all know that OMB has repeatedly refused your requests for more examiners despite the fact that you are really short of examiners. We know that your attempts to try and get the administration to deal with the shortage of money at the FSLIC have met deaf ears.

Do you have any, even a peep of a friendly voice in the administration?

I know you have come around and talked to some of the members of this committee about the issue. Do you make the rounds of the White House and try to do the same?

I know you are a loyal person. I am not asking you to knock them. I am just saying, the history of this administration is to ignore banking problems until they are already upon us.

Treasury Secretary Donald Regan was telling us there was no crisis in the IMF in August when, in September, the whole thing exploded. He was telling us to do nothing.

Now, what is going on, because we need the administration to deal with this problem.

Mr. GRAY. Well, we are, I believe, working on a more cooperative and productive basis with OMB than ever before.

Mr. SCHUMER. Is it going to change? Are they going to allow you to get more examiners or even ask for them?

Mr. GRAY. Well, our examiners, of course, already have been transferred out to the Federal home loan banks, so that is not within our purview.

Mr. SCHUMER. We are going to let the home loan bank do that.

Mr. GRAY. We have indeed requested more people at the FSLIC and I am very hopeful we will get substantially greater staffing at the FSLIC.

Mr. SCHUMER. They have rejected you in the past; is that accurate?

Mr. GRAY. Well, we have not been as successful as we would have liked.

Mr. SCHUMER. You have answered my question.

The second question I had was: Do you think the time would come when you might have to actually ask the Congress and the administration to appropriate more money for the FSLIC's coffers?

I realize you are even having some trouble on your own Board with your 1-percent proposal, and yet we have to do something.

Mr. GRAY. Well, our 1-percent proposal was one of the alternatives that was available.

One of the problems here is that if we defer losses and they pile up and they cost us more down the road, we can maintain a level of reserves, either unobligated reserves, et cetera, but somebody, in my view, is going to have to pay the piper at some time. If we were to resolve these cases at a rate that we would like to resolve them and save some money by earlier resolution, we could quite easily find ourselves without sufficient reserves.

Mr. SCHUMER. When would that be? Last year you had over $5 billion of unencumbered capital. This year you have $3.2 billion of unencumbered capital. That is not even counting net worth certificates, the number of potential liquidations that are lined up now and you have slowed down on them at least partly because you only have 19 people in the whole liquidation department.

Mr. **Gray**. Professionals, right.

Mr. **Schumer**. So not even counting that, if failure went on at the present rate in the thrift industry, No. 1, and No. 2, you didn't hold them back because of a lack of money, lack of examiners, or lack of liquidators but no new money was put into FSLIC, when would you run out? Would it be about year from now? Is that accurate?

Mr. **Gray**. In all honesty, it would depend on how quickly we move to resolve cases.

Mr. **Schumer**. Let's assume these are cancers or something bad hanging around. Let's say you moved to resolve all the cases and the new ones came in at the same rate, not at an accelerated rate, which they have been coming in. Wouldn't you run out of money in about year?

Mr. **Gray**. Well, we could run out of money much sooner than that if we chose to resolve cases more quickly or more expeditiously, which we have not felt the ability to do.

Mr. **Schumer**. Right.

But the long and short is, we could say in all fairness that if we were to try and resolve all these cases and not just keep them hanging around, that the outside amount of time that FSLIC would have left as a financially viable institution is year. I think that is a very important point that we all ought to be aware of.

My final question relates to proposals to merge all of the various regulatory institutions. I am sorry I wasn't here for your testimony. Did you address that in your testimony?

Mr. **Gray**. If you are talking about merging of the insurance funds, I did.

Mr. **Schumer**. You did? All right. Then I won't ask that question.

Thank you, Mr. Chairman

Chairman **St Germain**. Chairman Gray, I have just been discussing with your General Counsel this increase in the number of examiners that we certainly agree with. However, as we were discussing, in many of the bank failures where we have gone into it very thoroughly, and we have had quite a few hearings on individual bank failures for varying reasons, what we have found is that the examiners did indeed spot a great many problems, but it ended there.

Once it got to the supervisor, that was the end. Particularly, let's point out Penn Square in Oklahoma, that shopping center bank was in part responsible for bringing down Continental Illinois.

Mr. **Gray**. Right.

Chairman **St Germain**. The examiners spotted the problems. They brought them, the board of directors, into the Comptroller's Regional Office, but there was no communication with the other regional offices saying, hey, you better watch any participations being purchased from this particular institution. I am hopeful that as you go along—and we appreciate your problems—that you will not lose sight of the experience that we have come across and that while it is all well and good to have excellent examiners who will do a good job, it can't stop there.

There has to be a follow through.

Mr. **Gray**. May I comment on that?

Chairman **St Germain**. Yes, sir.

Mr. **Gray**. We have doubled in little more than year the number of supervision staff at the Federal home loan banks already. The Bank Board has sent out explicit instructions to all of the supervisory agents in our system that any material violation of any regulation, statute, or supervisory agreement previously entered into requires the immediate request by the supervisory agent of a cease-and-desist order or a reason why such a request is not being made.

Chairman **St Germain**. Well, that is really and truly gratifying. Let's go on to something else and then I will come back to this briefly.

I understand that in an effort to conserve Federal Savings and Loan Insurance Corporation resources, the Board has entered into a number of what I referred to earlier as management contracts on behalf of FSLIC.

Now, my understanding of these contracts is that you bring in for a 90-day period——

Mr. **Gray**. Or longer.

Chairman **St Germain** [continuing]. Or longer, but at least a 90-day period—expert management. In other words, CEO's of successful institutions, who have agreed to assist you, and sometimes bring additional personnel from their own institutions. Is that correct?

Mr. **Gray**. Yes.

Chairman **St Germain**. They are three-man teams.

Mr. **Gray**. Or more.

Chairman **St Germain**. How many contracts of this type are now outstanding and how many do you estimate will be necessary in the short-term future?

Mr. **Gray**. There are 17, I believe, outstanding, and we have seen certainly the possibility of doing as many as 70.

Chairman **St Germain**. Now, in these instances, FSLIC, the insuring fund, becomes the receiver?

Mr. **Gray**. Yes.

Chairman **St Germain**. These institutions begin with a negative net worth; isn't that correct?

Mr. **Gray**. Yes.

Chairman **St Germain**. They have a negative net worth. Now, to prevent them from operating, how do they achieve a positive net worth?

Mr. **Gray**. The Bank Board has provided in all cases, virtually all cases, income capital certificates to bring these institutions up above zero net worth.

Chairman **St Germain**. Now, what are the total ICC's outstanding today?

Mr. **Gray**. In these management consignment programs, it is $523 million, and I believe we also have about a total of $1.4 billion in income capital certificates outstanding.

Chairman **St Germain**. Now, if you go from 17 to 70 in these institutions, then what would be the amount of the ICC's?

Can you estimate that for us?

Mr. **Gray**. One could only speculate because it depends——

Chairman **St Germain**. It was a range.

Mr. **Gray**. We are looking at the possibilities of $1 billion in income capital certificates.

Chairman **St Germain**. The reason I wanted to go into that in light of what I was asking earlier, is because I understand in a meeting that we had audited, many of these management teams did, indeed, bring up the fact that it was unfortunate that some of these institutions couldn't have been placed under the supervision of the type they are receiving now at a much earlier date. Is that not correct?

Mr. **Gray**. Yes.

Chairman **St Germain**. This, again, points out the importance of the examination and supervision function of the agency.

Mr. Vento.

Mr. **Vento**. Well, Mr. Chairman, I don't really have very many questions. On this particular program, is there—with these individuals coming in, these team contracts—I guess I am not versed in that very well.

How do you avoid certain conflicts? If these individuals are from financial institution teams, will they in the end have conflicts of interest in this instance at all, Mr. Gray?

Mr. **Gray**. The kinds of people that we bring in to do the management contracts, per se, are people that we have great confidence in and who run institutions where their expertise has demonstrated a great capacity for running an institution and spotting problems.

We also, in addition to these management consignment contracts, appoint in these cases generally five people who are, on occasion, from the savings and loan industry at the present time, but for the most part, they are people who have retired, were from auditing firms and others who have substantial real estate expertise.

They serve as the board of directors for these new institutions when they reach insolvency and are taken into receivership by the FSLIC, and this new program is established.

Mr. **Vento**. So, you believe you have at least diminished that greatly by virtue of the persons that you are selecting of their noninvolvement as a retired executive in this instance, Mr. Gray.

Mr. **Gray**. In these cases, we have some former chief executive officers of some of the best-run institutions in the United States and they have a great deal to provide. They do it at very, very little cost and the institution and the FSLIC benefits from their expertise and willingness to serve.

Mr. **Vento**. I am looking through a staff proposal that is before me, the Federal Home Loan Bank Board proposal, Thrift Regulatory Improvements Act of 1985. Has this been actually submitted—have you actually submitted this proposal to the Congress or is this—this explanation was preliminary in nature, I am certain.

Mr. **Gray**. Well, let me try to answer that. When Mr. Stearns appeared before this same subcommittee a few weeks ago, he was asked by one of the Members for, I believe, draft language of a deposit set-aside proposal which was subsequently again requested. In that particular conversation, the request was made for us to also include some other items which, in a streamline fashion, might be what this committee would like to look at, and we provided that on the request of the Member.

Mr. VENTO. The point is, this has not received the support of the Federal Home Loan Bank Board to date. It may in the future?

In other words, it is not affirmative action on your part in terms of support or proposal?

Mr. GRAY. Congressman, what we have tried to do—I know you weren't here—we have tried to go over a range of alternatives, presenting few, unfortunately, to recapitalize the fund, from funding by the taxpayers, how the fund could be recapitalized by the industry, whether the Federal home loan banks ought to contribute reserves to this, for this purpose, et cetera, and so one of the alternatives that was provided was this particular one.

Mr. VENTO. I understand. We appreciate your willingness to do that. I guess I think that if we are going to have—I think you are well aware of it—you have to build some consensus on the Board for proposals because I think the stakes here are very high.

I think the S&L's or the thrifts that are impacted, obviously there is going to be—without some sort of consensus position on the Federal Home Loan Bank Board, I don't think it is going to be likely we are going to build the type of political or policy support that is desirable.

Mr. GRAY. Congressman, when you come to difficult choices there are always upsides and downsides. There are some downsides to the proposal that I discussed earlier. Among the down-sides are that well-capitalized institutions with good shops would in effect conceivably, if that proposal were adopted, be called upon to expend, depending on the size of the institution, vast amounts right out of their net worth to support that program.

I don't think we can ignore that either. We have nothing but poor choices here under the circumstances.

Mr. VENTO. I think most of the proposals—I mean the extension of Garn-St Germain, the new regulatory powers or the redefinition of regulatory powers, the one that really seems to bite is the second one where we talk about the insurance premium authorization, the 1 percent—no, that is not it. The 1 percent set-aside. Is that correct?

Mr. GRAY. Yes.

Mr. VENTO. The point is the impact of that would be negative, is your point, or at least somewhat negative on institutions of good health.

Mr. GRAY. It would provide additional money, no question about it, to the extent it were drawn down. On the other hand, it would represent a very substantial penalty to these well-run institutions. I don't think we can ignore the positives and the negatives of any particular option that we can look at.

Mr. VENTO. In other words, you are saying that even from a regulatory standpoint, if we would permit it and say it could be counted as an asset, it still would have negative effects? We can't legislate away the effect of the market place to judgments on that?

Mr. GRAY. As long as it were counted as an asset, there would be no problem. The problem arises when that asset; is drawn down. Then it is no longer an asset; it is an expense. It is in effect a net loss to the institution against which it is expensed.

Mr. Vento. Can you think of any legislative means to remedy that with respect to that 1 percent? I think it is possible. I can envision it.

I am not proposing it, but I can envision it. Is there a remedy to that? I think the answer is, yes, there is. It is not a very pleasant one, I guess, for us, or for you, but I think that we probably can do that. Obviously, just, if not saying so, legislatively—I don't have the legislative language in front of me.

Mr. Gray. Are you talking about how you treat that for accounting purposes?

Mr. Vento. For accounting purposes, you obviously have remedies that. This measure remedies that, I assume.

Mr. Gray. There is a question. If that were the option chosen, it is quite possible that the law would have to specify that the deposit would be held as an asset.

Mr. Vento. I think the problem is that, Mr. Chairman, we want to try and resolve this with the least amount of risk and the least amount of cost to see if we can, in essence, "bad term grow" our way out of this particular problem.

I think that is what everyone wants to do. Maybe that isn't feasible and maybe we can't, but I think obviously that is far better for instance than leaving a massive failure of these institutions.

I think all of us want to avert that. The question is, can we do it by virtue of this particular measure, if we can remedy the type of asset problems that occur here?

I see you are nodding your head.

Mr. Gray. I would say it is simple to me. If that proposal would be followed, you would have institutions putting up, say, $8.5 billion in deposits. They would count it as an asset and might receive a yield roughly equivalent to what Government securities yield unless and until there was a drawdown to pay for losses.

At that time, it becomes very difficult for institutions that have so many deposits up there to set-aside.

Mr. Vento. I think the missing link is, where is the Congress going to get the money to put in there? Is that better than allocating $10 or $12 billion to bail them out? Is this better than having their money upfront and we come in as necessary? That is really the point.

If we do that, then I think no matter what the marketplace judgment, we would do the best we can to protect it and save the thrift industry.

So I think that is what we are looking at.

Mr. Gray. All of these are rough choices on us.

Mr. Vento. I think the question really is—I speak for myself and other members of the committee interested in solving this problem—that we are only interested in this as a solution if it holds a good prospect to work.

I am not interested in going through this machination and then next year having you come back in for something else.

Mr. Gray. I understand that and I would agree with that.

Mr. Vento. Very good.

Thank you, Mr. Chairman.

Chairman St Germain. This probably will require a legal opinion to be submitted in writing, but we would like to know if the Federal Home Loan Bank Board could indeed pass a resolution that would force the 12 district banks to grant a loan from the banks to the FSLIC. Have you already looked into this?

Mr. Raiden.

Mr. RAIDEN. We believe under the regulations of the Board that the Board can require the home loan banks to lend to the FSLIC.

That is not to say that the Board could force them to invest in common stock of a 406 corporation.

Chairman ST GERMAIN. Thank you.

Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman.

I would like to welcome Chairman Gray before the subcommittee today.

Yesterday, I introduced, with the cosponsorship of two-thirds of the members of the Banking Committee, legislation which is designed to strengthen the examination process by providing greater flexibility to the Federal regulators to more adequately compensate their examiners and to also try and strengthen and perhaps coordinate somewhat the training that is going on for examiners.

I understand from your testimony that you assigned your examiners from the Bank Board to the home loan banks earlier this summer and I basically just want to ask—you are sort of a test case for us and because we envision taking a similar kind of approach with some other agencies.

I would like to just ask you to comment on how that process has worked. I would presume you have had to move your employees from under the auspices of the civil service to some other range.

I would presume there are some budgetary implications. I don't know if you have encountered any problems along the way. I would be interested in knowing the reaction of your employees to the move.

Mr. GRAY. Well, we started that process in November of last year when we first began discussing it, as you can understand, there were some grave concerns on the part of some of our field examiners and some of our district examination chiefs. But as we talked about it at greater length, as we met with field examiners over a period of time, as our principal supervisory agents in the Federal home loan banks did this, as members of the Bank Board did, as a matter of fact, and as these people came to understand the financial benefits which would accrue to them by moving out of the civil service system into the home loan bank system, so by the time we reached July 7 of this year there was no question in our mind we were prepared to do this.

Now, since they have gone to the Federal home loan banks, which incidentally must pay the cost of examination, but the cost, on the other hand, is passed on to member institutions being examined, the budgetary implications are easily handled by our Federal home loan banks, very easily and I think that we have happier people under the circumstances.

I think we are going to have a much better chance to retain these kinds of people because we have no salary setting constraints to inhibit providing salaries that are competitive enough to keep them and certainly hold down the kind of turnover that we were having before.

Mr. **Carper**. Let me ask you a question, if I could, relating to the turnover. I think you said it was roughly 33 percent and you are turning your employees over about every 3 years.

Mr. **Gray**. The 33 percent is in the FSLIC, but we had five districts where turnover in our examination districts ranged from 23 to 28 percent, so it approaches that.

Mr. **Carper**. It would seem at least in those districts no sooner would you have trained a person to do an adequate job than you find that person leaving to go on to some other gainful employment.

I would be interested to know if, you face a significant training challenge. How do you go about training new employees and, as you have that kind of turnover, how do you insure that the quality of the training is reasonable?

The second part to the question is, how does the training of your examiners, if at all, how does it dovetail with the training of State examiners, people who are examining on a State level any thrift institutions or maybe with the other Federal examiners?

Can you help me at all with that, please?

Mr. **Gray**. The Bank Board has an annual appropriation of $500,000 included in its budget which is earmarked for the training of State examiners. These moneys which cover both tuition and travel costs for State examiners, are expended in accordance with the decisions of the Joint Committee on Examinations which consists of representatives of the Bank Board and the State authorities. This training effort is designed to assure that the State examiners have access to the same training offered to the Federal Home Loan Bank System examiners in order to enhance the ability of the State examiners to more fully participate in joint examination. While the specific training is furnished by various sources, including the Bank System Office of Education. Which is headquartered in Dallas, the program is wholly funded and administered by the Bank Board staff.

Mr. **Carper**. All right. Thank you very much.

Chairman **St Germain**. Chairman Gray, when you consider the quick turnover or the mortality rate, so to speak, frankly, civil service really didn't provide that much to those employees. In other words, by transferring out of civil service and going to go work for the Federal Home Loan Bank Board, what did they lose if anything?

Mr. **Gray**. Some of them thought it did, though.

Chairman **St Germain**. But upon reflection, if they are going to have such a short life under civil service, it is not really that big a deal. I bet you will be happy to hear this.

One last question. Before I ask the last question, I have to tell you.

Mr. **Gray**. I am glad I didn't have any water this morning.

Chairman **St Germain**. You knew you were coming before this chairman; right?

Mr. **Gray**. I did.

Chairman **St Germain**. Forewarned is forearmed—or something to that effect. I have to compliment you again. You have done an excellent job this morning and you are always a good advocate for the industry, and the Federal Home Loan Bank Board and the FSLIC.

I am wondering if you or your erudite staff could enlighten me. We had a very long staff meeting in fact, I got sick of looking at my staff yesterday. We covered many items in about 4 or 5 hours, particularly that which we covered today. One of my staff them made reference to the fact that—remember when Financial Corp. of America was in the throws of its problems? I am sure it will be a long time before you forget that one because there, again, you did a good job.

One of my staff told me that he recollected they had an inordinate number of Mercedes Benzes which they had purchased for their people that were selling brokered deposits. Is that correct?

Mr. Gray. They had an inordinate number of Mercedes Benzes and other kinds of automobiles, Porsches—you name it.

Chairman St Germain. Porsches?

Mr. Vento. Rolls Royces?

Mr. Gray. I believe they had nine airplanes.

Chairman St Germain. Roughly how many Mercedes?

Mr. Gray. I am told by a staff member that there were—and I don't recall this myself—but there were 450 Mercedes and Porsches.

Chairman St Germain. Four hundred fifty Mercedes and Porsches?

Chairman Gray, would you support a "Buy American" bill? No. 1, why do they need a Mercedes Benz or a Porsche to sell broker deposits. But, second—goodness gracious. We have all these problems with providing employment in the United States of America, so maybe next time you could recommend a little "Buy American" amongst your supervisory tools.

Mr. Gray. I like that idea very much.

Chairman St Germain. Chairman Gray, again, you did a great job and we are very grateful.

The subcommittee will be in recess.

[Whereupon, at 1 p.m., the subcommittee adjourned.]

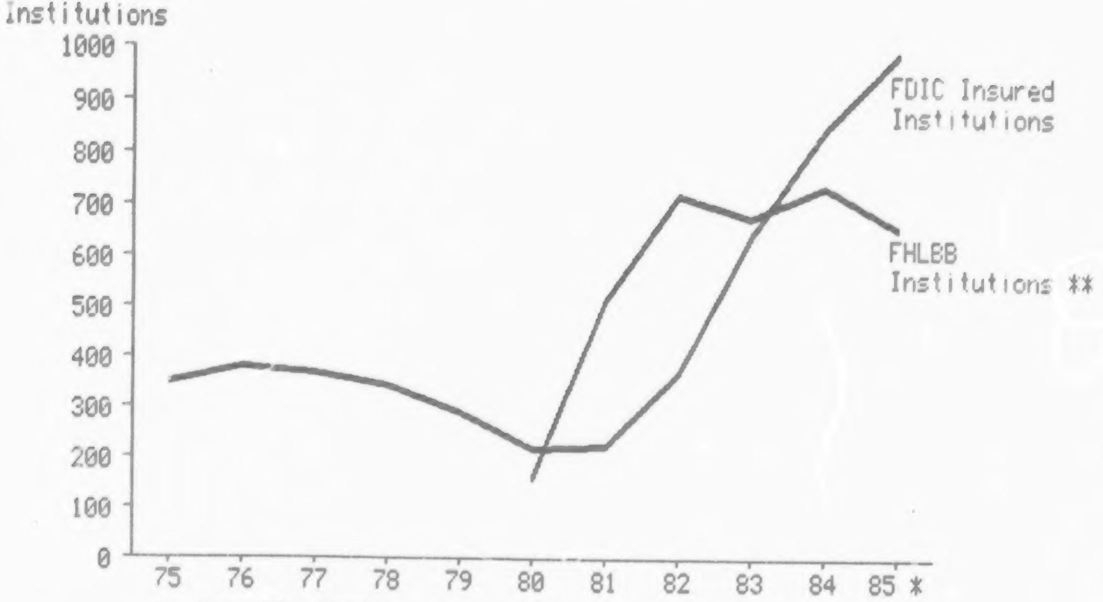
[The following material and letter of invitation to Chairman Gray were submitted for inclusion in the record:]

DEPOSITORY INSTITUTIONS
STATISTICAL INFORMATION

Prepared for the Use of
The Members of
The Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
House Committee on Banking, Finance and Urban Affairs
by the
Subcommittee Staff
with the assistance of
Dr. William Jackson
Congressional Research Service

October 17, 1985

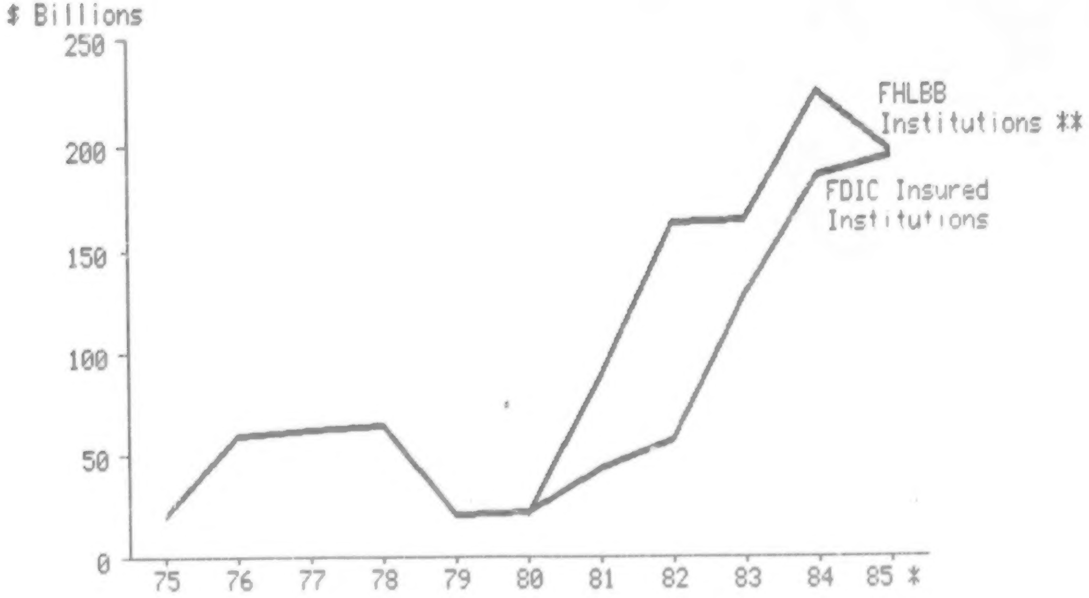
Problem Institutions, Number



* June 30, 1985 Data

** 1980 4th Quarter Data Only

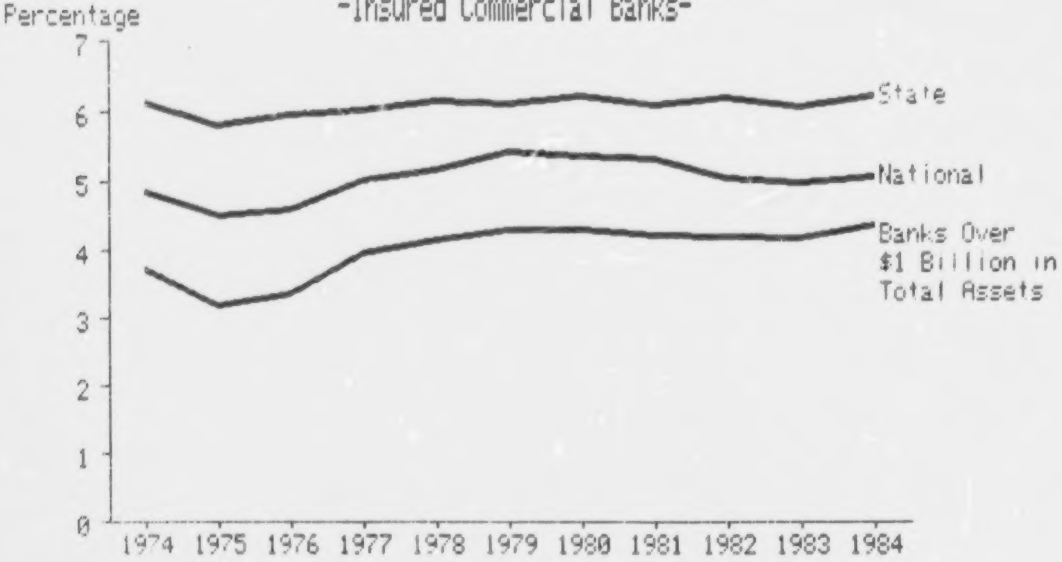
Problem Institutions, Total Deposits



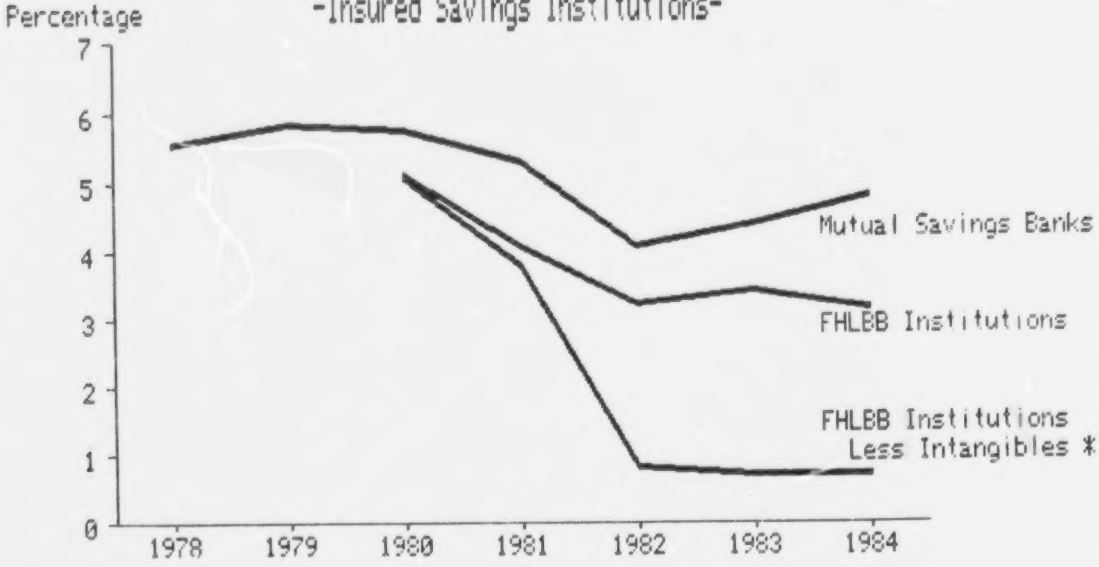
* June 30, 1985 Data

** Estimated, 1980 4th Quarter Data Only

Equity and Reserves Less Classified Assets As A Percentage of
Total Assets Plus Standby Letters of Credit
-Insured Commercial Banks-



Equity and Loan Loss Reserves Less Classified Assets As A Percentage of Total Assets -Insured Savings Institutions-



* Excludes goodwill and other intangibles

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Committee on Financial Institutions

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1985
Banking, Finance & Urban Affairs Committee

September 26, 1985

The Honorable Fernand J. St Germain
Chairman of The House Banking Committee
2129 Rayburn House Office Building
Washington, D.C. 20515

RE: FDIC Reform

Dear Congressman St Germain:

I have been following with great interest, your hearings on the FDIC reform question and believe there are two problems; protection of the system itself, and protection of the savers and investors. Both of these matters can be handled easily as follows:

1. All demand deposits and one-day Federal Reserve funds should be insured without limit by the FDIC. This would make certain that if a large bank went down, payrolls would be met, other banks would stay alive, and the system would not grind to a halt.
2. All other funds would be insured without limit, but would have a 10% deductible beyond $50,000 and 20% deductible beyond $100,000.

When the Continental Bank got into trouble, General Motors had $350 million in CD's. By using the above method, they would have had a maximum of $70 million at risk. In addition, all foreign deposits should be insured and premiums paid on them.

One of the serious problems we now have in Finance is the new breed of "wild men and crap shooters" in control of banks and Savings & Loans, who can fund their operation by simply paying higher and higher rates even though there is nothing responsible they can do with such high cost money. They will be curtailed better than regulators can do, if savers and investors know they might lose something. For that reason, I would abandon the sacred cow of $100,000 insurance and move it down to an area that covers 98% of all the non-commercial public, say $50,000.

In summary, you would offer $50,000 protection to all savers and investors and a deductible above that. But with such a deductible, even the Bureau of Indian Affairs would be cautious as to where they put tribal money. A balance must be struck between the public's natural avarice and fear of loss.

Protecting savers and investors can best be done with 100% insurance with deductibles and secondly, the protection of this system, which could be currently described as a giant fly-wheel going at incredible speed. Demand deposits in New York City turn over 500 times a year. That is more than twice per working day. That system must be protected or we could have a national calamity.

I am available to testify before your committee should you find these points interesting. Also, enclosed please find some expanded thoughts on the problems. To my knowledge, no one has ever discussed these concepts before.

Very truly yours,

GPF/pjd
enc.

F.D.I.C. NARRATIVE

Fifty years ago when the F.D.I.C. was founded, its function was to save the small despositor from the immediate problems associated with bank failures. Although the banks were to pay the premiums on their deposits, to fund the insurance reserve, the administration and rule of the fund was left in the political province, that is, with the administration and Congress. During the years, the amounts guaranteed each depositor increased as the numbers of bank failures diminished, and until about a decade ago, the fund could have been deemed actuarially sound.

In its first move to bring discipline to what was becoming an unstable banking and thrift market, the F.D.I.C.'s sister organization, the F.S.L.I.C. moved to liquidate a savings and loan and not absorb the losses via a merger. This left a number of depositors with over $40,000 with losses. The fall out from this was extensive enough that within days, thrifts across the country were crying for the level of deposit insurance to be raised from $40,000 to $100,000 or they warned Congress to expect runs on their associations. With little hesitation, Congress voted to amend the F.D.I.C. & F.S.L.I.C. insurance program and the increased depositor coverage was put in place, and probably for the first time, insuring more deposits than funds could pay. The events of the past 12 months have shown that as much as the F.D.I.C. and the F.S.L.I.C. wish to bring discipline to the market, events can over run their acts and intentions.

Had the run on the Continental Illinois Savings Bank, not been stopped, a measure of terror would have spread through the banking system, greater even than that of the early 1930's. The bank had to be saved and their is almost no one who doubts it. The method for saving it, however, was to use the F.D.I.C. fund which was apparently the most convenient thing available. The net effects of this was varied and unfortunate. It gave the signal that one's money is safe in large institutions no matter how ill managed they may be. It gave out the signal that large banks do not need liquidity and it placed a tax on thousands of large and small well-managed institutions who will have to replenish the funds should any net losses occur beyond their shareholders equity in Continental Illinois National Bank. It should be remembered that the banking industry has no representatives on the F.D.I.C. board, yet they pay the price. What has been hailed as a government bailout of Continental, is essentially a bankers bailout. It is in effect an added tax on the banking system which will be passed on to all depositors. The government and banking system are left with a greater problem than ever before. How does one keep discipline with the large banks if their depositors know they cannot fail and have nothing at risk? Logical depositors must absolutely read this as telling them there is going to be more risk in depositing with small banks. Clearly, it is time to review the entire structure of deposit insurance.

Let us first look at the anatomy of a large bank failure such as the Continental. Had it failed in the traditional way, depositors within a week would have received their funds up to $100,000 on their demand and quasi-demand accounts, and up to

$100,000 as their time deposits matured. Large corporations with more than $100,000 on deposit, with bills to pay, payrolls to meet, would have been in a gigantic crunch and in many cases faced ruin. Banks with their high powered overnight excess Federal Reserve funds, (incidentally left with large banks by only the most liquid and soundest, smaller institutions,) would in numerous cases have failed. It must be remembered that the Continental Bank cleared 1,400,000 checks each day for several thousand correspondent banks. In a flash, a chain reaction of multiple bank failures was a possibility and thousands of companies, would be unable to meet payroll or pay bills, which would cause wide spread unemployment and dislocation. It is not hard to see the scenario on the failure of one large bank such as the Continental putting 5 million people out of work in less than a month.

The banking authorities in the U.S. and the rest of the world, understand the situation and with a quasi-formal arrangement, swarm to support each other to prevent such an international catastrophe. This is probably all correct and proper, as the world is far more interdependant than it was 50 years ago.

To quickly illustrate what has happened to velocity of money, demand deposits in checking accounts in the American banking structure at the end of World War II turned over 26 times a year or twice a month. Today, demand deposits in New York City turn over 500 times a year, or put another way, twice every business day. The collectibility of these funds rests solely on the confidence of the system. This excessive velocity, borders on being a gigantic kite. But this isn't the worst of the matter. New electronic speed up systems such as Chips and Swift are capable of transferring the same dollars between banks 500 times in one day, and computer specialists say it is only the beginning. The money that is being transferred as demand deposits is the grease which keeps the wheels of commerce turning. It must be protected. The aspect of inner bank relationships; that is, one-day Fed funds must also be protected because it is the grease that keeps the banking wheels turning free and furnishes an unrestricted flow of funds from banks oversupplied with funds to those in need of them. Because of the high-powered nature of these funds as differentiated from savings accounts and certificates of deposits, they must never be in jeopardy and they must be instantly available to their owners. Because of this, I recommend that all Federal Reserve excess funds bought and sold between banks on a one day basis, be 100% guaranteed by the FDIC. In addition, all demand deposits on non-interest bearing funds, be guaranteed without limit. Practically no one today leaves excess funds in their demand deposit account. With high interest rates available elsewhere, demand deposits have become a shrinking proportion of the available funds which depositors use, because of the greater velocity of turnover and the high rates of interest available elsewhere.

For all other deposits, I would have 100% guarantee up to $50,000. Between $50,000 and $100,000, there should be a 10% deductible, limiting the loss that anyone could take. For deposits over $100,000, there should be a 20% deductible. This would allow the regulators to maintain a new discipline over the banking industry by forcing the depositor to consider whether the top rate is worth the risk. We have had a rash of "wild men" in financial circles, particularly in the thrift industry. Nothing will cool a depositors greed faster than the recognition that the institution offering a 2 percent higher interest rate than a sound institution, puts his money at risk.

We have witnessed in the Chicago area, a Savings & Loan grow from $30 million to over $1 billion in a two year period be the simple device of paying higher rates than anyone else. They, of course, must invest those funds in riskier loans than they should, and this remarkable "Ponzi" scheme is possible because of the absolute guarantee of the F.S.L.I.C. My own preference is that there should be a rising deductible from the lowest rates, but I am told it is politically impossible. The above proposal would bring disipline to the market and at the same time allow large banks to fail as they should be able.

Another problem of large banks is not very well recognized, either by the banks themselves, and certainly not by Congress and Administration. With communications perpetually speeding up information available, the national corporations have had no trouble at all avoiding the banking system via commercial paper. It would be very easy for one to make a case that the large commercial banks no longer have any high rated loans to big corporations. They are indeed stuck with lending gigantic sums of money to smaller and lesser quality corporations and ventures. This is true because of the prohibition against investment banking. They should be allowed to sell commercial paper. It would in the long run bring considerably greater balance to the structure. It would give the banks better capital asset ratios, put more of the risk where it belongs with the depositor, allow the banks fee income, and in general be extraordinarilly beneficial.

ADDITIONAL RANDOM THOUGHTS ON FSLIC & FDIC REFORM

CAPITAL REQUIREMENTS

Both Chairman Paul Volker of the Fed and Mr. William Isaac of the FDIC have suggested that 9% is the appropriate capital level for banks. It will clearly be incredibly destructive to the banking industry unless other competitors including Sears Roebuck, are required to maintain 9% capital for their banking functions. Investment bankers run without comparable capital and S&Ls are supposed to have 3% capital, yet they are in direct competition with banks. We would have no objection to the 9% capital as long as all our competitors have the same. Unfortunately, bank examiners look for the simplest possible way to do their job, and forcing the banks to have more capital certainly is much easier than learning to examine in depth the entire asset quality of a bank and then monitoring it. As a friend of mine observed, everyone in this world is inclined to do what they do best. Bank examiners ask for more capital, just as Congress finds it easier voting to spend money than to cut spending. This is another reflection of that phenomenon.

INTERMEDIATE TERM PROBLEMS OF LARGER BANKS

For some years now more and more of America's giant corporations have turned away from banks to borrow funds and gone to the commercial paper market. The commercial paper market requires no capital nor reserves. This market has grown continuously until now it is $___billion or ____% greater than the entire lending portfolio of commercial banks. Of the 1000 largest corporations in America, 800 no longer have need for direct bank loans nor can banks be competitive in dealing with them. The 200 large corporations left in the banks are of course weaker and are unable to issue commercial paper. We have seen this grow for the past 35 years at an ever increasing rate with only one sizable setback, that of the collapse of Penn Central Railroad which cooled off the commercial paper market for a short while. It is not difficult to foresee that 80% of the 5000 largest corporations in America will be using commercial paper 20 years from now, leaving the large lending banks to pursue riskier and riskier creditors in lesser developed countries, the oil patch, leveraged buy outs and highly leveraged entrepeneurial situations. It is bleak indeed, and Congress will be remiss as has the Fed in facing this problem.

L.D.C's

The failure of the large banks and the regulators to do anything about the LDC's, borders on being scandalous. These loans, which are not worth the carrying values, cannot be paid off in their present form. They must either be rewritten at easier terms, reserved for or converted into equity where applicable. In the depths of the Continental Bank crisis, it was observed that the FDIC could not take out the LDC's from Continental's portfolio without causing trauma throughout the banking industry. The appropriate way to approach this would be for the examiners to call all the banks with these problems together and tell them that effective this or that date, they will reserve such and such a percentage for them, these banks could all reduce their dividend or eliminate them simultaneously. To date, only the Bank of America has reduced its dividend and that wasn't related to the LDC's. As British bankers commented to me four or five years ago, each bank in America with these loans should suspend its dividend until they can restore their capital position and I wholeheartedly agree.

OFF BALANCE SHEET LIABILITIES

The Federal Reserve and other examiners are absolutely correct in requiring capital for "off balance sheet" liabilities. Letters of credit, interest rate swaps, and other devices, designed to hold down asset growth but assume off balance sheet commitments, should require capital.

FOREIGN DEPOSIT INSURANCE

It is the pinnacle of folly that small banks should pay insurance premiums on all their deposits and large banks like the Continental pay premiums on only their domestic deposits and yet have defacto insurance on their foreign deposits. This is a great injustice to banks that do not have foreign deposits.

CONTINENTAL BANK BAIL OUT

While I absolutely approve of the actions of the Administration and the regulators in bailing out the Continental, I question their current laissez faire attitude towards the Continental which is now using the premiums put in by the banking industry to expand. As an example, they are building a ten story banking facility in Elk Grove, Illinois, the capital requirements of which are greater than the entire deposit structure of our competing bank. We have now a nationalized Continental Bank with unlimited ability to spend, if not taxpayers funds, the insurance reserves of their prudent competitors who didn't get themselves in trouble. Any fair minded person would find this quite extraordinary. While I don't believe the Continental should be liquidated, I believe they should be shrinking continuously until they get down to a size where they have a higher proportion of core deposits than the now "Government guaranteed" hot money.

The same of course could be said of nationalizing S&L's and other Thrifts. While not suggesting they should all be liquidated, I would be willing to make that suggestion if we are forced to continue to subsidize our failed competition. Paying once for your competitors blunders should be enough. We shouldn't have to re-subsidize them.

FAMILY BANKING - SEARS, ETC.

We believe Sears, Household Finance and anyone should be allowed to get into the banking business as long as they have to cope with the regulators as we do. It will be very interesting to see if Sears would like to put up 9% capital to run a bank and have reserve requirements. unfortunately people on the periphery of banking are trying to play the game with different rules.

BANK CAPITAL AND INFLATION

There is probably no industry in America more vulnerable to inflation's ravages than Banks & Thrifts. This is because we are limited by law in America to holding monetary assets, and other than our building, furniture and fixtures, we have nothing that will rise with price increases; indeed all our assets values fall with inflation. It should also be very clear to everyone that banks cannot earn capital as fast as the Fed can print money. Every time a billion dollars is printed, the banking system is $60 million short of capital. Continuous U. S. deficit financing will unquestionably destroy the banking system as it is currently positioned.

BRANCH BANKINGS AND INTERSTATE BANKING

Let's have it! We are not afraid to compete and we think we can run circles around the muscle bound monsters.

FINANCE COMPANIES UNBUNDLING

For years, the Justice Department massaged the computer industry to unbundle software from computer sales. We have a much more competitive and vigorous market since that has been done. For the life of me I cannot understand why the Justice Department allows General Motors and Ford to make new auto loans under market rates to avoid lowering their auto prices. Besides causing great disruption to commercial financial channels, it is just plain bad public policy to put a floor under auto prices through this device.

DEREGULATION IN GENERAL

It is beneficial because it forced us to be more competitive and to give the consumer a better shake. Everyone is benefited by it except those who try to avoid competing. It has saved the Railroad Industry, revitalized the Trucking and Air Transport Industry and should have long term beneficial effects for the Banking and Thrift Industries, giving the public more value for its hard-earned money. While I have no illusions that banks will ever be totally deregulated, nor should they, the results so far certainly justify the efforts.

BANKERS' ASSOCIATION FOR FOREIGN TRADE

1600 M Street N.W., Seventh Floor, Washington, D.C. 20036
Tel: (202) 452-0952

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Subcommittee on Financial Institutions

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EXECUTIVE DIRECTOR
MARY CONDEELIS
WASHINGTON, D.C.

October 10, 1985

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions Supervision,
Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
United States House of Representatives
Rayburn House Office Building
Room 2129
Washington, D.C. 20515

Re: Hearings on Deposit Insurance Reform

Dear Chairman St Germain:

The Bankers' Association for Foreign Trade ("BAFT") is a trade association of money-center, regional and smaller banks dedicated to promoting international trade and finance. Its 135 voting members comprise virtually all U.S. banks actively involved in international banking and trade finance.

In connection with the Subcommittee's hearings on possible reforms to the deposit insurance system, we note that, at several points, the issue has been raised of whether foreign branch deposits of U.S. banks should be subject to FDIC premium assessments. In this regard, BAFT has prepared a statement on this issue which is enclosed and which addresses the major public policy detriments which we believe would result from FDIC assessments on foreign branch deposits. We respectfully request that this statement be included in the record of the hearings.

In BAFT's view, extending FDIC premiums to cover foreign branch deposits of U.S. banks is unnecessary from a fairness standpoint and counterproductive from a risk standpoint. The only certain result is that the added costs of

FOSTERING SOUND INTERNATIONAL BANKING SINCE 1921

assessments would make it more difficult for U.S. banks to compete abroad and to finance the international needs of their U.S. customers on a competitive basis. This result is certainly not in the public interest when the U.S. is facing record merchandise trade and balance of payments deficits and when substantial efforts are being made to reduce barriers to U.S. banks abroad.

Sincerely,

David H. Dorminey
President

DHD/jyh
cc: The Honorable Chalmers P. Wylie
Ranking Minority Member

All Members of the Subcommittee on Financial Institutions Supervision, Regulation and Insurance

STATEMENT OF THE

BANKERS' ASSOCIATION FOR FOREIGN TRADE

IN OPPOSITION TO PROPOSALS TO IMPOSE FDIC ASSESSMENTS ON FOREIGN BRANCH DEPOSITS OF U.S. BANKS

SUBMITTED TO:

Subcommittee on Financial Institutions Supervision,
Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
United States House of Representatives

October 10, 1985

INTRODUCTION

For fifty (50) years, it has been the public policy of the United States to exclude deposits at foreign branches of U.S. banks from Federal Deposit Insurance Corporation ("FDIC") assessments and coverage. This policy was established in 1935 and reaffirmed by Congress in 1981 when it also exempted deposits at International Banking Facilities ("IBFs") from FDIC assessments and coverage, because the additional costs associated with FDIC assessments would put U.S. banks at a serious disadvantage in competing internationally.

Recently, however, proposals have been made to impose FDIC assessments on foreign branch deposits of U.S. banks as a way of increasing the size of the FDIC fund and of making large money-center banks pay more premiums into the fund. The Bankers' Association for Foreign Trade ("BAFT"), a trade association of 135 U.S. banks actively involved in international banking and trade finance, is strongly opposed to such proposals because they would clearly be detrimental to the foreign trade, economic, and foreign policy interests of the United States and would likely increase systemic risks to the U.S. and international banking systems.

ASSESSMENT OF FOREIGN BRANCH DEPOSITS IS UNNECESSARY

Proposals to include foreign branch deposits in the FDIC assessment base have generally been based on either of two premises.

First, it has been suggested that assessing foreign branch deposits of U.S. banks would be one way of increasing the size of the FDIC fund. However, officials of the FDIC have consistently stated that the size of the FDIC fund is adequate. As of July 31, 1985, the FDIC had assets of $23.8 billion and an insurance fund of over $18.8 billion. Simply put, there has been no showing to date that the FDIC needs additional funds, whether derived from assessment of foreign branch deposits or other sources.

Second, it has been suggested that assessment of foreign branch deposits is "fair" because such deposits are de facto insured by the FDIC. Because section 3(l) of the FDIC Act expressly excludes foreign branch deposits from FDIC insurance, such suggestion has apparently been based on the premise that any bank having foreign branches is "too big to fail" and its foreign depositors would thus be made whole by the FDIC. We believe that premise is wrong on several counts.

Firstly, the premise that some banks are "too big to fail" is merely a hypothesis: it is neither proven fact nor established public policy. As the Subcommittee's hearings have already demonstrated, opinions differ sharply over the validity of this premise. In this connection, the Subcommittee has already received a number of thoughtful suggestions from bank trade associations and other witnesses for approaches to dealing with bank failures which would ensure that no bank is too big to fail, i.e., that all banks regardless of size would be treated equally in a failure situation. We note further that, at his recent confirmation hearing, Mr. Seidman stated that (if confirmed as Chairman of the FDIC) he would like to come up with a plan "that makes it clear that all banks, no matter what the size, can be treated in the same way under similar circumstances."1/ Even Chairman Isaac, who has supported including foreign branch deposits in the FDIC assessment base, admitted in testimony before the Senate Banking Committee that if foreign branch deposits could be excluded from (*de facto*) coverage then there would be no reason to assess them.2/

Secondly, the "too big to fail" premise begs the obvious question of which banks are "too big to fail." Who draws this line and where is it drawn? Federal Reserve figures indicate that 166 U.S. banks have foreign branch operations. If foreign branch deposits were assessed, would that mean that

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1/ Transcript of September 19, 1985 at 24.

2/ Transcript of July 23, 1985 at 23.

all such 166 banks would be "too big to fail"? If not, would it be fair to require banks to pay assessments on their foreign branch deposits when, in fact, their foreign branch depositors would not be covered by the FDIC?

Lastly, the "too big to fail" concept turns the basic purpose of the FDIC on its head. Under such concept, instead of being an insuror of U.S. retail deposits, the FDIC would become an implied guarantor of the worldwide operations of U.S. banks. We respectfully submit that such a radical change in the FDIC's mission has implications far beyond the assessment of foreign branch deposits.

ASSESSMENT OF FOREIGN BRANCH DEPOSITS IS DETRIMENTAL TO BROADER PUBLIC POLICY INTERESTS OF THE U.S.

Each time Congress has looked at the issue of whether foreign branch deposits should be assessed and insured -- in 1935 and again in 1981 in connection with IBFs -- it has concluded that assessment of such deposits would seriously harm the ability of U.S. banks to compete in international markets, and that such harm outweighed any marginal increases to the FDIC fund.

Given this longstanding public policy, those who may propose assessing foreign branch deposits must bear the burden of demonstrating that this change would not seriously damage the competitive position of U.S. banks abroad. From our standpoint as a trade association of international bankers, the competitive reasons which led to the exemption of foreign branch deposits from FDIC assessments are even more compelling today than they were 50 years ago when the original exemption was enacted.

First, international trade is much more important to the U.S. economy today than it was fifty years ago. International markets are also much more competitive today than they were fifty years ago, as U.S. businesses and banks find themselves competing with an ever-growing list of highly sophisticated and sometimes government-owned or supported foreign businesses and banks.

Second, services are now the most important segment of the U.S. economy, and are the key to the future competitiveness of the U.S. in international markets. The Trade in Services Study, which was submitted by the United States to the General Agreement on Tariffs and Trade ("GATT") in December 1983, stated that services, including government, now account for two-thirds of U.S. gross national product and 70 percent of U.S. employment. The United States is the largest exporter of services ($34.9 billion in 1980), and it is believed the amount of U.S. service sector exports are much greater than those reported. In this connection, in a study done for the

Departments of State and Commerce and Office of U.S. Trade Representative, an independent consultant estimated that foreign revenues from the international business operations of the U.S. banking industry in 1980 were $9.1 billion (on a net basis), making banking the second largest U.S. service sector internationally in terms of revenue.

Third, U.S. banks' share of world banking assets has decreased markedly over the past decades, as competition from large foreign banks has intensified. After the end of World War II, U.S. banks held approximately 50% of the assets of the world's 100 largest banks. By the end of 1983, the percentage had declined to 14%.

Lastly, given a mechandise trade deficit approaching $150 billion and a growing balance of payments deficit, now is not the time to take actions which would make it more difficult for U.S. banks and their customers to compete abroad.

REDUCED U.S. INTERNATIONAL COMPETITIVENESS

U.S. banks play a double role in American trade competitiveness. There is a direct role, in that service exports are extremely significant to the overall U.S. balance of payments and help to compensate for the widening U.S. merchandise trade deficit. As previously noted, banking is the second largest U.S. service sector internationally in terms of revenue. In addition, U.S. banks finance U.S. exporters.

Should U.S. banks' ability to function in international markets be damaged, so will their ability to service American exports.

There is no doubt that FDIC assessments would put U.S. banks at a serious competitive disadvantage in international markets. Intense competition in foreign markets has created spreads which are relatively thin, especially in such important operations as interbank placements. FDIC assessments would result in a tax of 6-8 basis points on all international deposit transactions.1/ U.S. banks would not be able to pass this tax on to their customers because, since their major competitors are foreign banks which do not bear this cost, passing it through would make U.S. banks' prices noncompetitive. This added tax would simply be another disadvantage imposed on U.S. banks in their efforts to compete with foreign banks that frequently operate under foreign government ownership or support with lower capital ratios, lower effective reserve requirements, and generally fewer operating constraints. In this connection, U.S. banks have been losing market share and are now second

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1/ The current FDIC assessment rate is 1/12 of 1% or 8.3 basis points. Senator Proxmire proposed last year an assessment rate of 1/15 of 1% or 6.7 basis points on all deposits, including foreign branch deposits. While rebates could theoretically reduce these rates, international banking transactions cannot be priced on the basis of future rebates which may or may not occur. In this regard, since 1980, FDIC rebates have varied substantially due to increased bank failures.

to Japanese banks in the international market. See Exhibit A. Given the thinness of margins in the Euromarkets -- frequently as low as 25-40 basis points -- it is clear that even a 6-8 basis points added cost could make a critical difference in many transactions.

The ultimate problem is not simply a loss of business or reduced profits for U.S. banks, developments which, in and of themselves, would hurt the U.S. balance of payments. If U.S. banks are burdened by a special FDIC tax which does not apply to foreign banks, then it becomes more difficult for them to extend competitive international financing to their U.S. customers who must compete for foreign sales against non-U.S. companies financed by non-U.S. banks. The result will be reduced U.S. exports at a time when we are facing a record merchandise trade deficit.

REDUCED LIQUIDITY IN THE EURODOLLAR MARKET

Access to the Eurodollar market is an important component in U.S. bank liquidity. This market is primarily a wholesale market, and for banks which are active in international lending, it acts as a source of deposits as well as an important tool in the management of interest maturity exposure. Purchases of deposits and of foreign exchange in the Eurodollar market allow banks to hedge and protect themselves from volatility in interest rate and foreign exchange risks. The interbank market endows U.S. banks with maximum flexibility and liquidity -- both of which heighten bank safety by increasing the ability to meet unforeseen needs.

The liquidity of this market has already been attenuated by the impact of international credit problems and increased U.S. bank capital ratios, which have resulted in a reduced level of interbank placing. In 1981, U.S. banks' claims on foreign banks, i.e. liquid Eurodollar deposits, totalled $150 billion: by year-end 1984, this source of liquidity had shrunk by one-third to $100 billion. See Exhibit B. FDIC assessments on foreign branch deposits would exacerbate this diminution in liquidity, as premiums would be assessed on each international deposit transaction -- resulting in fewer transactions and a further decline in overall liquidity (gross turnover in the Eurodollar market today exceeds the net loans and deposits, since a deposit made with one bank may be on-lent through several banks before reaching the ultimate borrower). Less liquidity clearly means less capacity on the part of U.S. banks to manage risk and to support U.S. industry's international financial needs.

SPECIAL DISINCENTIVES TO REGIONAL BANKS

Contrary to conventional wisdom, the impact of FDIC assessments on foreign branch deposits may, in the long run, be more damaging to the international operations of regional banks than money-center banks. While money-center banks would face significant increases in FDIC assessments if foreign branch deposits were covered, such banks may be able to reduce the impact of such assessments through the increased use of foreign subsidiaries and non-deposit funding strategies. Regional banks lack the extensive networks and resources to reduce the impact of FDIC assessments and are thus likely to experience a more direct bottom-line impact on their international earnings. As a result of the thinness of international spreads and higher capital requirements, many regional banks are already cutting back their international activities by closing foreign offices and reducing interbank placements and lending activities. The additional costs associated with FDIC assessments may cause a further retrenchment of regional banks' international activities at a time when they are being encouraged to maintain their crucial role in financing the exports of middle-market and smaller U.S. customers and in lending to the LDCs. A reduced role for regional banks means less U.S. exports, less needed new money for the LDCs, and a further concentration of international lending at the major money-center banks, developments which would be harmful to interests of the U.S. and the world's trading and financial system.

INCREASED RISKS TO THE FDIC FUND AND FOREIGN POLICY COMPLICATIONS

If foreign branch deposits of U.S. banks were to become subject to FDIC assessments, then such deposits would presumably be covered by FDIC insurance, greatly increasing the exposure of the FDIC fund. Even if such deposits were not **de jure** covered, the fact that they were being assessed would create the strong implication of **de facto** coverage by the FDIC. Such **de jure** or **de facto** coverage could result in significant legal problems for the FDIC and in potential foreign policy problems for the U.S. For example, in 1984, the Philippine Treasury exhausted its supply of foreign currency and the government prohibited local banks -- including local branches of U.S. banks -- from repaying dollar deposits upon maturity. With foreign deposits assessed and **de jure** or **de facto** insured by the FDIC, such situations would be open invitations to depositors to sue the local U.S. bank branches and their insurer, the FDIC, to obtain their funds. Similar calls on the FDIC could arise in conjunction with other events (which have occurred) such as foreign government expropriation of U.S. bank branches. These and many other novel legal and supervisory problems could increase risks to the FDIC fund and, in many cases, could cause unwarranted regulatory or foreign policy problems with host country governments.

FOREIGN DEPOSIT ASSESSMENTS ARE INCONSISTENT WITH GREATER RELIANCE ON MARKET DISCIPLINE

Imposition of FDIC assessments on foreign branch deposits would be convincing evidence of a moral and supervisory commitment by the FDIC to stand behind the worldwide operations of U.S. banks. Such a commitment reduces the market discipline which exists today in international funding markets, a discipline which the FDIC wishes to enhance and which is the most effective check on undue risk in banking operations. By weakening market discipline and establishing **de jure** or **de facto** coverage of worldwide operations, FDIC assessments on foreign branch deposits would thus increase, rather than decrease, the systemic risks now faced by the FDIC.

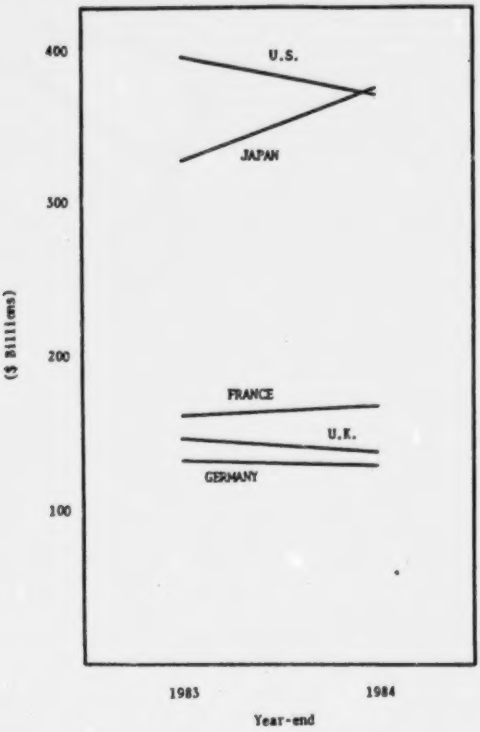
CONCLUSION

Proposals to include foreign branch deposits in the FDIC assessment base are based on a "too big to fail" hypothesis which is unproven, which is unfair to regional and smaller banks, especially with foreign branch operations, and which would entail a radical change in the FDIC's mission. Continued exemption of foreign branch deposits from FDIC assessments is based on a longstanding and sound policy of maintaining the competitiveness of U.S. banks in international markets. A change in this policy to assess foreign branch deposits would result in reduced competitiveness of U.S. banks in foreign markets, reduced U.S. exports, reduced lending to small businesses involved in international activities, reduced lending to the LDCs, reduced competition in international lending among U.S. banks, reduced liquidity in international markets, and reduced market discipline in international banking. While such assessments might provide a small increase in FDIC income, that increase would be dwarfed by increased risks to the FDIC fund, increased systemic risks to the international banking system and increased legal and supervisory problems.

In sum, BAFT believes extension of FDIC assessments to the foreign branch deposits of U.S. banks would be contrary to the public policy interests of the United States.

EXHIBIT A

INTERNATIONAL ASSETS OF BANKS BY COUNTRY OF PARENT BANK



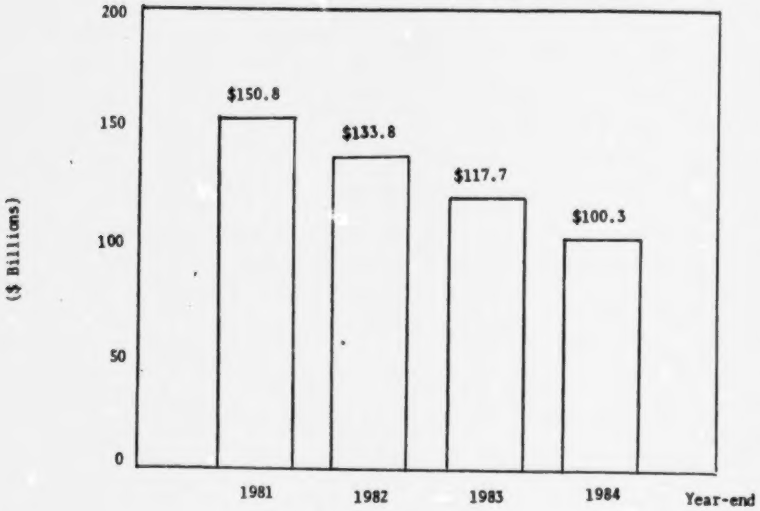
DATA:
(in billions)

	Assets	Market Share	Assets	Market Share
	1983		1984	
U.S.	$393.7	26.4%	$369.5	24.4%
Japan	$376.2	21.9%	$372.1	24.6%
France	$160.8	10.8%	$167.7	11.1%
U.K.	$146.9	9.9%	$137.1	9.1%
Germany	$132.0	8.9%	$129.6	8.6%
All Other	$331.5	22.1%	$335.8	22.2%
TOTAL	$1491.1	100%	$1511.8	100%

SOURCE: BIS, May 10, 1985, "The Nationality Structure of the International Banking Market and the Role of Interbank Operations".

EXHIBIT B

INTERBANK PLACINGS OF U.S. BANKS TO FOREIGN BANKS



DATA:
(in billions)

Year	Placings
1981	$150.8
1982	$133.8
1983	$117.7
1984	$100.3

SOURCE: Federal Reserve Bulletin - TABLE 3.14

HENRY B. GONZALEZ, TEXAS
FRANK ANNUNZIO, ILLINOIS
PARREN J. MITCHELL, MARYLAND
WALTER E. FAUNTROY, DISTRICT OF COLUMBIA
STEPHEN L. NEAL, NORTH CAROLINA
CARROLL HUBBARD, JR., KENTUCKY
JOHN J. LAFALCE, NEW YORK
STAN LUNDINE, NEW YORK
MARY ROSE OAKAR, OHIO
BRUCE F. VENTO, MINNESOTA
DOUG BARNARD, JR., GEORGIA
ROBERT GARCIA, NEW YORK
CHARLES E. SCHUMER, NEW YORK
BARNEY FRANK, MASSACHUSETTS
BUDDY ROEMER, LOUISIANA
RICHARD H. LEHMAN, CALIFORNIA
BRUCE A. MORRISON, CONNECTICUT
JIM COOPER, TENNESSEE
MARCY KAPTUR, OHIO
BEN ERDREICH, ALABAMA
SANDER M. LEVIN, MICHIGAN
THOMAS R. CARPER, DELAWARE
ESTEBAN E. TORRES, CALIFORNIA
GERALD D. KLECZKA, WISCONSIN
BILL NELSON, FLORIDA
PAUL E. KANJORSKI, PENNSYLVANIA
BART GORDON, TENNESSEE
THOMAS J. MANTON, NEW YORK
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J. ALEX McMILLAN, NORTH CAROLINA

(202) 225-4247

September 24, 1985

Honorable Edwin J. Gray, Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Chairman Gray:

To assist this Subcommittee in its evaluation of the need for modifications in the present system of federal deposit insurance, you are requested to appear before the Subcommittee on October 17, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on deposit insurance reform. In your testimony, please comment specifically on the matters enumerated below.

A. What is your agency's position on the following deposit insurance reform proposals:

(1) Modified Payoff
(2) Subordinated Debt Capital
(3) Risk-related Deposit Insurance Premiums
(4) Risk-related Capital Requirements
(5) Insurance Fund Recapitalization
(6) Insurance Fund Merger
(7) 100% Deposit Insurance Coverage
(8) Reduced Deposit Insurance Coverage
(9) Increased Disclosure
(10) Intensified Supervision
(11) Increased Examiner Staffing and Compensation
(12) Market Value Accounting
(13) Private Deposit Insurance
(14) Brokered Deposit Restrictions
(15) Insurance Premiums on Foreign Deposits

B. For your agency and for each year from 1975 to the present, please provide the following:

(1) Field examiner staffing pattern
(2) Field examiner turnover rate
(3) Minimum and maximum salaries paid to field examiners (nominal and adjusted for changes in the Consumer Price Index)

Please also provide the Subcommittee with a discussion of the optimal staffing pattern and compensation rates, and what statutory changes are needed, if any, to attain it.

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building twenty-four hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing record, and if delivered as requested, the statement will be made available to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to fifteen minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv